CAMBRIDGE

Professional English in Use

Finance

Ian MacKenzie

Contents

BANKING

CORPORATE FINANCE

1 Money and income

A Currency

The money used in a country – euros, dollars, yen, etc. – is its **currency**. Money in **notes** (**banknotes**) and **coins** is called **cash**. Most money, however, consists of **bank deposits**: money that people and organizations have in bank accounts. Most of this is **on paper** – existing in theory only – and only about ten per cent of it exists in the form of cash in the bank.

BrE: note or banknote; AmE: bill

B Personal finance

All the money a person receives or **earns** as payment is his or her **income**. This can include:

- a **salary**: money paid monthly by an employer, or **wages**: money paid by the day or the hour, usually received weekly
- **overtime**: money received for working extra hours
- **commission**: money paid to salespeople and agents – a certain percentage of the income the employee generates
- a **bonus**: extra money given for meeting a target or for good financial results
- **fees**: money paid to professional people such as lawyers and architects
- **social security**: money paid by the government to unemployed and sick people
- a **pension**: money paid by a company or the government to a retired person.

Salaries and wages are often paid after deductions such as social security charges and pension contributions.

Amounts of money that people have to **spend** regularly are **outgoings**. These often include:

- **living expenses**: money spent on everyday needs such as food, clothes and public transport
- **bills**: requests for the payment of money owed for services such as electricity, gas and telephone connections
- **rent**: the money paid for the use of a house or flat
- a **mortgage**: repayments of money borrowed to buy a house or flat
- **health insurance**: financial protection against medical expenses for sickness or accidental injuries
- **tax**: money paid to finance government spending.

A financial plan, showing how much money a person or organization expects to earn and spend is called a **budget**.

BrE: social security; AmE: welfare
BrE: flat; AmE: apartment

Planned monthly budget for next year (€)

Income		Outgoings	
Salary (after deductions)	3,250	Rent	900
Commission (average)	600	Bills	250
		Living expenses	1,200
		Health insurance	130
		Tax	800
Total	**3,850**	Total	**3,280**

1.1 Complete the sentences with words from the box. Look at A and B opposite to help you.

commission	bonus	currency	earn	mortgage	tax
overtime	pension	rent	salary	social security	

1 After I lost my job, I was living on .... for three months. This was difficult, because the amount was much lower than the .... I had before.

2 I used to work as a salesperson, but I wasn't very successful, so I didn't .... much ....

3 If the company makes 10% more than last year, we'll all get a .... at the end of the year.

4 It'll take me at least 25 years to repay the .... on my house.

5 Many European countries now have the same .... , the euro.

6 My wages aren't very good, so I do a lot of ....

7 Nearly 40% of everything I earn goes to the government as ....

8 The owner has just increased the .... on our flat by 15%.

9 When I retire, my .... will be 60% of my final salary.

1.2 Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 Bank deposits are not classified as money.
2 People earning wages get paid more often than people earning a salary.
3 People working on commission always get paid the same amount.
4 When you stop working at the end of your career, you receive a pension.
5 Most people pay a rent and a mortgage.

Over to you

Do you know what the average income is in your country, and in your job, or the one you are studying for? How important is salary in your choice of career?

2 Business finance

A Capital

When people want to **set up** or start a company, they need money, called **capital**. Companies can **borrow** this money, called a **loan**, from banks. The loan must be paid back with **interest**: the amount paid to borrow the money. Capital can also come from issuing **shares** or **equities** – certificates representing units of ownership of a company. (See Unit 29) The people who **invest** money in shares are called **shareholders** and they **own** part of the company. The money they provide is known as **share capital**. Individuals and financial institutions, called **investors**, can also **lend** money to companies by buying **bonds** – loans that pay interest and are repaid at a fixed future date. (See Unit 33)

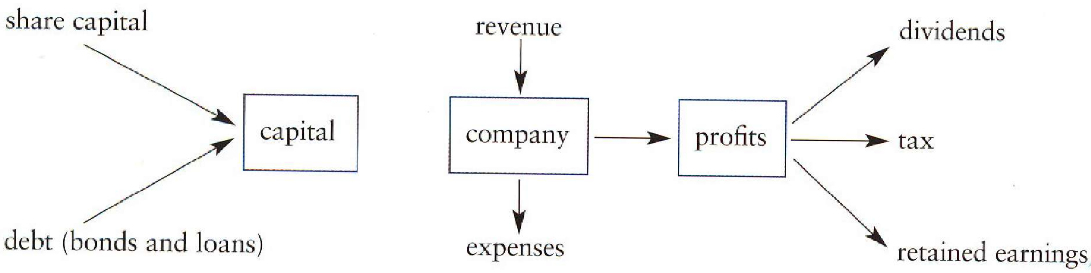
Money that is **owed** – that will have to be paid – to other people or businesses is a **debt**. In accounting, companies' debts are usually called **liabilities**. Long-term liabilities include bonds; short-term liabilities include debts to suppliers who provide goods or services **on credit** – that will be paid for later.

The money that a business uses for everyday expenses or has available for spending is called **working capital** or **funds**.

BrE: shares; AmE: stocks
BrE: shareholder; AmE: stockholder

B Revenue

All the money coming into a company during a given period is **revenue**. Revenue minus the cost of sales and operating **expenses**, such as rent and salaries, is known as **profit**, **earnings** or **net income**. The part of its profit that a company pays to its shareholders is a **dividend**. Companies pay a proportion of their profits to the government as **tax**, to finance government spending. They also **retain**, or keep, some of their earnings for future use.

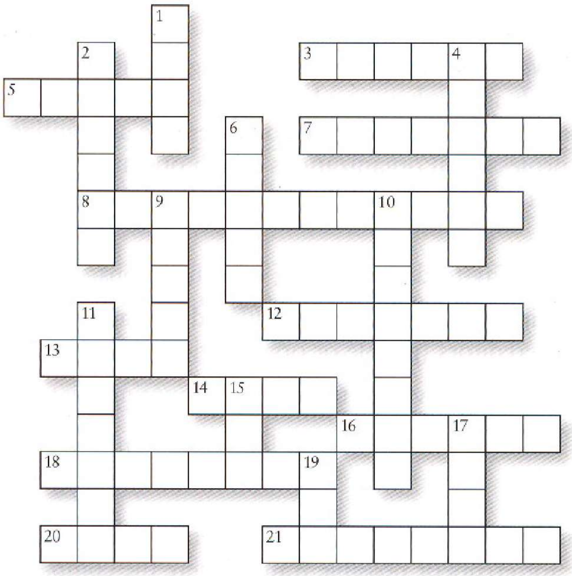


C Financial statements

Companies give information about their financial situation in **financial statements**. The **balance sheet** shows the company's **assets** – the things it owns; its liabilities – the money it owes; and its capital. The **profit and loss account** shows the company's revenues and expenses during a particular period, such as three months or a year.

BrE: profit and loss account; AmE: income statement

2.1 Complete the crossword. Look at A, B and C opposite to help you.



Across

3 Small companies often try to get bank loans when they need to .... money. (6)
5 We don't have sufficient .... to build a completely new factory. (5)
7 and 6 down Details of a company's liabilities are shown on the .... (7,5)
8 We're going to raise more money by selling new shares to our existing .... (12)
12 We had to raise €50,000 .... in order to start the business. (7)
13 We're going to pay back some of the people who lent us money, and reduce our .... (4)
14 I decided to buy a $10,000 .... instead of shares, as it's probably safer. (4)
16 Another term for profit is net .... (6)
18 I think this is a good investment: it pays 8% .... (8)
20 When they saw our financial statements, the bank refused to .... us any more money. (4)
21 Profit is the difference between revenue and .... (8)

Down

1 The profit and .... account shows if a company is receiving more money than it's spending. (4)
2 If you don't like taking risks, you should only .... in very successful companies. (6)
4 A company's retained earnings belong to its .... (6)
6 See 7 across.
9 Anything a company uses to produce goods or services is an .... (5)
10 The company made such a big profit, I expected a higher .... (8)
11 We sold a lot more last year, so our .... went up. (7)
15 We .... our suppliers $100,000 for goods bought on credit. (3)
17 Everyone who buys a share .... part of the company. (4)
19 Thirty per cent of our profits goes straight to the government in .... (3)

"It's been a great year – let's hope we can keep the shareholders from finding out."

Over to you

Think of the company you work for, or one that you are interested in. How was it financed when it was set up, and how is it financed now?

3 Accounting and accountancy

A Accounting

- **Accounting** involves **recording** and summarizing an organization's **transactions** or business deals, such as purchases and sales, and reporting them in the form of financial statements. (See Units 11–14) In many countries, the accounting or **accountancy** profession has professional organizations which operate their own training and examination systems, and make technical and ethical rules: these relate to accepted ways of doing things.
- **Bookkeeping** is the day-to-day recording of transactions.
- **Financial accounting** includes bookkeeping, and **preparing** financial statements for shareholders and **creditors** (people or organizations who have lent money to a company).
- **Management accounting** involves the use of accounting data by managers, for making plans and decisions.

B Auditing

Auditing means examining a company's systems of control and the **accuracy** or exactness of its records, looking for errors or possible **fraud**: where the company may have deliberately given false information.

- An **internal audit** is carried out by a company's own **accountants** or **internal auditors.**
- An **external audit** is done by **independent auditors**: auditors who are not employees of the company.

The external audit examines the truth and fairness of financial statements. It tries to prevent what is called '**creative accounting**', which means recording transactions and values in a way that produces a false result – usually an artificially high profit.

There is always more than one way of presenting accounts. The accounts of British companies have to give a **true and fair view** of their financial situation. This means that the financial statements must give a correct and reasonable picture of the company's current condition.

C Laws, rules and standards

In most continental European countries, and in Japan, there are **laws** relating to accounting, established by the government. In the US, companies whose stocks are traded on public stock exchanges have to **follow rules** set by the Securities and Exchange Commission (SEC), a government agency. In Britain, the rules, which are called **standards**, have been established by independent organizations such as the Accounting Standards Board (ASB), and by the accountancy profession itself. Companies are expected to **apply** or use these standards in their **annual accounts** in order to give a true and fair view.

Companies in most English-speaking countries are largely funded by shareholders, both individuals and financial institutions. In these countries, the financial statements are prepared for shareholders. However, in many continental European countries businesses are largely funded by banks, so accounting and financial statements are prepared for creditors and the tax authorities.

3.1 What type of work does each person do, and what is the name of each job? Look at A and B opposite to help you.

1 I record all the purchases and sales made by this department.

2 This month, I'm examining the accounts of a large manufacturing company.

3 I analyse the sales figures from the different departments and make decisions about our future activities.

4 I am responsible for preparing our annual balance sheet.

5 When the accounts are complete, I check them before they are presented to the external auditors.

3.2 Match the two parts of the sentences. Look at C opposite to help you.

1 In Britain
2 In most of continental Europe and Japan
3 In the USA
4 In Britain and the USA
5 In much of continental Europe

a accounting rules are established by a government agency.
b companies are mainly funded by shareholders or stockholders.
c accounting rules are set by an independent organization.
d the major source of corporate finance is banks.
e accounting rules are set by the government.

3.3 Find verbs in A, B and C opposite that can be used to make word combinations with the nouns below.

....
.... **an audit**

....
....
.... **standards**

....
....
....
.... **rules**

....
.... **transactions**

Over to you

Is accounting in your country based on standards, rules, laws, or a mixture of these? What accounting system do international companies in your country use?

5 Company law 1

A Partnerships

A **partnership** is a business arrangement in which several people work together, and share the risks and profits. In Britain and the US, partnerships do *not* have limited liability for debts, so the **partners** are fully liable or responsible for any debts the business has. Furthermore, partnerships are not legal entities, so in case of a legal action, it is the individual partners and not the partnership that is taken to court. In most continental European countries there are various kinds of partnership which *are* legal entities.

A **sole trader** business – an enterprise owned and operated by a single person – also has unlimited liability for debts.

B Limited liability

A **company** is a business that is a **legal entity**. In other words, it has a separate legal existence from its owners, the shareholders. It can enter into contracts, and can be sued or taken to court if it breaks a contract. A company can (in theory) continue for ever, even if all the staff and owners change. Most companies have **limited liability**, which means that the owners are not fully **liable for** – or responsible for – the business's debts. These companies are known as **limited companies**. Their liability is limited to the value of their **share capital**: the amount of cash that the shareholders have contributed to the company. This limitation of liability encourages investors to risk their money to become part owners of companies, while leaving the management of these companies to qualified managers and senior managers, known as **directors**.

These managers and full-time **executive directors** run the company for its owners. There are standard procedures of **corporate governance** – the way a company is run by the management for the shareholders, and how the managers are accountable to the shareholders. These include separating the job of **chairman** from that of **managing director**, and having several **non-executive directors** on the **board of directors** who do not work full-time for the company but can offer it expert advice. Non-executive directors are often more **objective**: less influenced by their opinions and beliefs. There is also an **audit committee**, containing several non-executive directors, to which the auditors report.

BrE: chairman; AmE: president
BrE: managing director; AmE: chief executive officer (CEO)

C Founding companies

When people **found** or start companies, they **draw up** or prepare **Articles of Association** and a **Memorandum of Association**. The Articles of Association state:

- the rights and duties of the shareholders and directors
- the relationships among different classes of shareholder (See Unit 29)
- the relationships between shareholders and the company and its directors.

The Memorandum of Association states:

- the company's name
- the location of the company's **registered office** – where to send official documents
- the company's **purpose** – its aims or objectives
- the **authorized share capital** – the maximum share capital it can have.

BrE: Articles of Association; AmE: Bylaws
BrE: Memorandum of Association; AmE: Certificate of Incorporation

5.1 Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 In case of a legal dispute, people can take a company's shareholders to court.
2 The owners of limited companies have to pay all the company's debts.
3 Many companies are not owned by their managers.
4 External directors can usually give more objective advice than full-time directors.
5 Partners in British and American businesses are not liable for the partnership's debts.
6 In case of a dispute, people can take British companies and partnerships to court.

5.2 Make word combinations using a word from each box. Then match the word combinations to the definitions below. Look at A opposite to help you.

corporate audit limited non-executive share	committee directors governance capital liability

1 ....: a group of directors to whom the external auditors present their report
2 ....: members of a board of directors who are not full-time managers of the company
3 ....: owners' money invested in a company
4 ....: responsibility for debts up to the value of the company's share capital
5 ....: the way a company is managed for its owners

5.3 Complete the document. Look at C opposite to help you.

(a) __________________ of Association

1. The name of the Company is Language Services Pty Limited.
2. The (b) __________________ of the Company will be in Australia.
3. The (c) __________________ for which the Company is established is to provide translation and interpreting services to international companies.
4. The (d) ________________________ of the company is made up of ordinary shares divided into five thousand (5,000) shares of A$1.00 par value each with one vote for each share.

Over to you

Do partnerships have limited liability in your country? If not, who would you trust enough to start a partnership with?

6 Company law 2

A Private and public companies

Private companies usually have 'Limited' or 'Ltd' at the end of their name. They are not allowed to sell their stocks or shares on an open market. Most companies are private; there are about one million private companies in Britain, compared to around 2,000 **public limited companies (PLCs)**. These companies have 'plc' at the end of their name, and their shares are publicly traded on the London Stock Exchange. A **stock exchange** is a market where anyone can buy stocks and shares. The US equivalent of a PLC is a company or **corporation** registered with the Securities and Exchange Commission (SEC).

SEC-registered companies, also known as **listed companies**, have to make **quarterly reports** (i.e. every three months). They report on:

- sales revenue or **turnover** – the money received by the company in that period from selling goods or services
- **gross profit** – turnover less cost of sales
- **net profit** – gross profit less administrative expenses and tax.

Companies on the London Stock Exchange, known as **quoted companies**, have to produce a half-yearly **interim report** which informs shareholders about the company's progress. These reports are not audited.

All companies with shareholders or stockholders have to send them an **Annual Report** each financial year. This contains a review of the year's activity, and an examination and explanation of the company's financial position and results. There are also financial statements and notes (see Units 11–14), and the **auditors' report** on the financial statements.

BARCLAYS PLC Interim Report 2004

- Group performance was very strong:
  - profit before tax up 23% to £2,411m
  - earnings per share up 25% at 26.7p
  - dividend per share up 17% to 8.25p
  - return on equity of 20.4%
- All businesses had higher profits, demonstrating good progress across the whole portfolio.
- Income growth was particularly strong, up 14%, with good broad based contributions by business and by income type.

B AGMs

Public companies have to hold an **Annual General Meeting** (AGM), and most private ones do too. At this meeting the shareholders can question directors about the content of the Annual Report and the financial statements, vote to accept or reject the dividend recommended by the directors, and vote on replacements for retiring members of the board. The meeting can also carry out any other business stated in the company's Memorandum of Association or Certificate of Incorporation, and Articles of Association or Bylaws.

If there is a crisis, the directors or the shareholders can request to hold an **Extraordinary General Meeting** (EGM) to discuss the situation. For example, if there are claims of **misconduct** by the directors, where they have behaved illegally, there could be an EGM.

BrE: Annual General Meeting (AGM); AmE: Annual Meeting of Stockholders
BrE: Extraordinary General Meeting (EGM); AmE: Special Meeting

6.1 Complete the table. Look at A and B opposite to help you.

(1) .... companies	Public companies	
	in the UK	in the US
■ can't sell shares on the (2)	■ are called public (3) .... companies or (4) .... companies.	■ are called SEC-registered companies or (6) .... companies.
	■ produce (5) .... reports.	■ produce (7) .... reports.
	■ publish an (8) .... and hold an (9)	

6.2 Find words in A and B opposite with the following meanings.

1 behaviour that breaks the law
2 sales revenue minus the cost of sales, before deductions for administration expenses, interest charges, etc.
3 sales revenue minus the cost of making and selling the goods, and deductions for administration expenses, interest charges, etc.
4 the total amount of money a company receives from selling goods or services

6.3 Match the two parts of the sentences. Look at A and B opposite to help you.

1 Only quoted or listed companies
2 American corporations publish details
3 Companies' financial statements, and the auditor's report,
4 Quarterly and six-monthly reports
5 Shareholders can ask company directors questions
6 Companies can hold an emergency general meeting

a about their sales and profits every three months.
b are contained in their annual reports.
c are not checked by external auditors.
d if there is a crisis.
e can have their shares traded on a stock exchange.
f at an annual meeting.

Over to you

Have you ever been to an AGM? Was there any disagreement between the shareholders and the directors? Who do you think is usually more powerful – the shareholders or the directors?

7 Accounting policies and standards

A Valuation and measurement

Investors in companies want to know how much the companies are worth, so companies regularly have to publish the value of their assets and liabilities. Companies also have to calculate their profits or losses: their managers need this information, and so do shareholders, **bondholders** and the tax authorities.

Companies can choose their **accounting policies** – their way of doing their accounts. There are a range of methods of **valuation** – deciding how much something is worth – and **measurement** – determining how big something is – that are accepted by law or by official accounting standards. In the USA, there are Generally Accepted Accounting Principles (GAAP). In most of the rest of the world there are International Financial Reporting Standards (IFRS), set by the International Accounting Standards Board. These are technical rules or **conventions** – accepted ways of doing things that are not written down in a law.

Although businesses can choose among different accounting policies, they have to be consistent, which means using the same methods every year, unless there is a good reason to change a policy: this is known as the **consistency** principle. The policies also have to be **disclosed** or revealed to the shareholders: the Annual Report will contain a 'Statement of Accounting Policies' that mentions any changes that have been made. This enables shareholders to compare profits and values with those of previous years.

Areas in which the choice of policies can make a big difference to the final profit figure include **depreciation** – reducing the value of assets in the company's accounts (see Unit 9), the valuation of stock or inventory, and the making of **provisions** – amounts of money deducted from profits – for future pension payments.

As there is always more than one way of presenting accounts, the accounts of British companies have to give **a true and fair view** of their financial situation – meaning there are various possibilities – rather than *the* true and fair view – meaning only one is possible.

BrE: depreciation; AmE: depreciation, amortization
BrE: a true and fair view; AmE: a fair presentation

B Historical cost and inflation accounting

The aim of accounting standards (see Unit 3) is to provide shareholders with the information that will allow them to make financial decisions. This is one reason why in many countries accounting follows the **historical cost** principle: companies record the original purchase price of assets, and not their (estimated) current selling price or replacement cost. This is more objective, and the current value is not important if the business is a **going concern** – a successful company that will continue to do business – as its assets are not going to be sold, or do not currently need to be replaced.

However, some countries with regular high inflation, e.g. in South America, use **inflation accounting** systems that take account of changing prices. One system used is **replacement cost accounting,** which values all assets at their **current replacement cost** – the amount that would have to be paid to replace them now.

7.1 Match the two parts of the sentences. Look at A and B opposite to help you.

1 Companies' managers, investors, creditors and the tax authorities all
2 There are different ways of doing accounting but companies have to be consistent,
3 Companies have to disclose or make known
4 The historical cost principle is that the price paid to buy assets,
5 A going concern usually doesn't

a and not their current value, is recorded in accounts.
b need to know the current market value of its assets.
c need to know about the size of profits or losses.
d which accounting methods they are using.
e which means regularly using the same methods.

7.2 Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 Companies are told which accounting policies to use.
2 Companies can change their accounting policies whenever they like, as long as they disclose this in their Annual Report.
3 Companies could produce several profit figures, depending on how they depreciated their assets, valued their inventory, etc.
4 There is only one correct interpretation of a company's financial position, and company accounts must show this.
5 In a lot of countries, companies do not record the current value of their assets.
6 In countries with high inflation, companies value their assets at their current replacement cost.

7.3 Complete the table with words from A and B opposite and related forms. Put a stress mark in front of the stressed syllable in each word. The first one has been done for you.

Verb	Noun(s)	Adjective
	calcu'lation	–
–		consistent
–		conventional
measure		–
present		–
		valuable

Over to you

Which are the most important accounting standards or rules in your country – GAAP, IFRS, IAS, or something else?

8 Accounting assumptions and principles

A Assumptions

When writing accounts and financial statements, accountants have to follow a number of assumptions, principles and conventions. An **assumption** is something that is generally accepted as being true. The following are the main assumptions used by accountants:

- The **separate entity** or **business entity** assumption is that a business is an accounting unit separate from its owners, creditors and managers, and their assets. These people can all change, but the business continues as before.
- The **time-period** assumption states that the economic life of the business can be divided into (artificial) time periods such as the **financial year**, or a quarter of it.
- The **continuity** or **going concern** assumption says that a business will continue into the future, so the current market value of its assets is not important. (See Unit 7)
- The **unit-of-measure** assumption is that all financial transactions are in a single monetary unit or currency. Companies with **subsidiaries** – that is, other companies that they own – in different countries have to convert their results into one currency in **consolidated financial statements** for the whole group of companies.

BrE: financial year;
AmE: fiscal year

B Principles

The following are the most important accounting principles (as well as the **consistency** principle and the **historical cost** principle, mentioned in Unit 7):

- The **full-disclosure** principle states that financial reporting must include *all* significant information: anything that makes a difference to the users of financial statements.
- The principle of **materiality**, however, says that very small and unimportant amounts do not need to be shown.
- The principle of **conservatism** is that where different accounting methods are possible, you choose the one that is least likely to overstate or over-estimate assets or income.
- The **objectivity** principle says that accounts should be based on facts and not on personal opinions or feelings. Accounts, therefore, should be **verifiable**: it should be possible for internal and external auditors to show that they are true. This isn't always possible, however: depreciation or amortization, and provisions for bad debts, for example, are necessarily **subjective** – based on opinions.
- The **revenue recognition** principle is that revenue is recognized in the accounting period in which it is earned. This means the revenue is recorded when a service is provided or goods delivered, not when they are paid for.
- The **matching** principle, which is related to revenue recognition, states that each cost or expense related to revenue earned must be recorded in the same accounting period as the revenue it helped to earn.

"New from accounting, sir. Two and two is four again"

8.1 Match the accounting assumptions and principles (1–6) to the activities they prevent (a–f). Look at A and B opposite to help you.

1 conservatism principle
2 matching principle
3 separate entity assumption
4 revenue recognition principle
5 time-period assumption
6 unit-of-measure assumption

a showing a profit divided into US dollars, euros, Swiss francs, etc.
b publishing financial statements for a 15-month period, because this will show better profits
c waiting until customers pay before recording revenue
d waiting until customers pay before recording expenses
e listing the owners' personal assets in a company's financial statements
f valuing assets and estimating future revenue at the highest possible figures

8.2 Complete the sentences. Look at A and B opposite to help you.

1 A company's .... does not have to begin on 1 January, like the calendar year.
2 If an American company owns a company in Britain, this is a ....
3 Multinationals, with companies in lots of different countries, combine all their results in one set of ....
4 Every entry in a company's accounts must be ....: there must be a document available showing that it is true.

8.3 Complete the table with words from A, B and C opposite and related forms. Put a stress mark in front of the stressed syllable in each word. The first one has been done for you. Then complete the sentences below with words from the table.

Verb	Noun	Adjective
as'sume		–
	disclosure	–
–	objectivity	
recognize		–
–	subjectivity	
	verification	

1 Both the internal and the external auditors have to .... the accounts.
2 Companies have to .... all relevant financial information in their annual reports.
3 Despite the .... principle, accountants have to make some subjective judgements.
4 Even if a company is going through a bad period, for accounting purposes we .... it's a going concern.

Over to you

Look at the Annual Reports of one or two companies. How many of the assumptions and principles described here are mentioned in the notes to the financial statements?

9 Depreciation and amortization

A Fixed assets

A company's assets are usually divided into **current assets** like cash and stock or inventory, which will be used or converted into cash in less than a year, and **fixed assets** such as buildings and equipment, which will continue to be used by the business for many years. But fixed assets **wear out** – become unusable, or become **obsolete** – out of date, and eventually have little or no value. Consequently fixed assets are **depreciated:** their value on a balance sheet is reduced each year by a **charge against profits** on the profit and loss account. In other words, part of the cost of the asset is deducted from the profits each year.

The accounting technique of **depreciation** makes it unnecessary to charge the whole cost of a fixed asset against profits in the year it is purchased. Instead it can be charged during all the years it is used. This is an example of the matching principle. (See Unit 8)

BrE: fixed assets; AmE: property, plant and equipment

B Valuation

Assets such as buildings, machinery and vehicles are grouped together under fixed assets. Land is usually not depreciated because it tends to **appreciate**, or gain in value. British companies occasionally **revalue** – calculate a new value for – appreciating fixed assets like land and buildings in their balance sheets. The revaluation is at either **current replacement cost** – how much it would cost to buy new ones, or at **net realizable value (NRV)** – how much they could be sold for. This is not allowed in the USA. Apart from this exception, **appreciation** is only recorded in countries that use inflation accounting systems. (See Unit 7)

Companies in countries which use historical cost accounting – recording only the original purchase price of assets – do not usually record an estimated **market value** – the price at which something could be sold today. The conservatism and objectivity principles support this; and where the company is a going concern, the market value of fixed assets is not important. (See Units 7 and 8)

C Depreciation systems

The most common system of depreciation for fixed assets is the **straight-line method,** which means charging equal annual amounts against profit during the lifetime of the asset (e.g. deducting 10% of the cost of an asset's value from profits every year for 10 years). Many continental European countries allow **accelerated depreciation:** businesses can deduct the whole cost of an asset in a short time. Accelerated depreciation allowances are an **incentive** to investment: a way to encourage it. For example, if a company deducts the entire cost of an asset in a single year, it reduces its profits, and therefore the amount of tax it has to pay. Consequently new assets, including huge buildings, can be valued at zero on balance sheets. In Britain, this would not be considered a true and fair view of the company's assets.

"Let's see, it says here that you've had a lot of corporate accounting experience ..."

9.1 Match the words in the box with the definitions below. Look at A and B opposite to help you.

appreciate	current assets	fixed assets
obsolete	revalue	wear out

1 to record something at a different price
2 assets that will no longer be in the company in 12 months' time
3 to increase rather than decrease in value
4 out of date, needing to be replaced by something newer
5 assets that will remain in the company for several years
6 to become used and damaged

9.2 Match the nouns in the box with the verbs below to make word combinations. Then use some of the word combinations to complete the sentences below. Look at A, B and C opposite to help you.

costs	fixed assets	market value
profits	value	purchase price

deduct .... **record** ....

depreciate .... **reduce** ....

1 Because we .... the .... , we don't have worry about the market value of fixed assets.
2 To depreciate .... , we .... part of their .... from profits each year.
3 Because land usually appreciates, companies do not generally .... its .... on the balance sheet.

9.3 Match the two parts of the sentences. Look at B and C opposite to help you.

1 All fixed assets can appreciate if there is high inflation,
2 Accelerated depreciation allows companies to
3 Fixed assets generally lose value, except for land,
4 The straight-line method of depreciation
5 Accelerated depreciation reduces companies' tax bills,

a which usually appreciates.
b charges equal amounts against profits every year.
c remove some extremely valuable assets from their balance sheets.
d which encourages them to invest in new factories, etc.
e but historical cost accounting ignores this.

Over to you

Are companies in your country allowed to record huge assets, such as their headquarters, as having zero value on their balance sheets? Is this a good idea?

10 Auditing

A Internal auditing

After bookkeepers complete their accounts, and accountants prepare their financial statements, these are checked by **internal auditors**. An **internal audit** is an **examination** of a company's accounts by its own internal auditors or **controllers**. They **evaluate** the **accuracy** or correctness of the accounts, and check for errors. They make sure that the accounts **comply with**, or follow, established policies, procedures, standards, laws and regulations. (See Units 7 and 8) The internal auditors also check the company's **systems of control**, related to recording transactions, valuing assets and so on. They check to see that these are adequate or sufficient and, if necessary, **recommend** changes to existing policies and procedures.

B External auditing

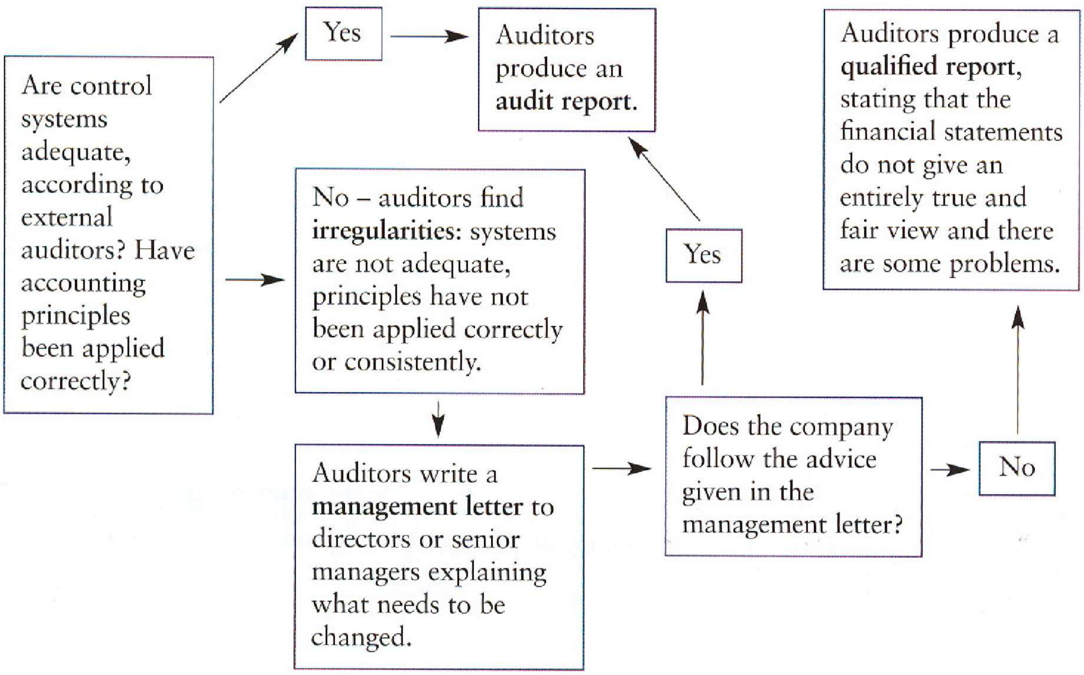
Public companies have to **submit** their financial statements to **external auditors** – independent auditors who do not work for the company. The auditors have to give an opinion about whether the financial statements represent a true and fair view of the company's financial situation and results. (See Unit 3)

During the audit, the external auditors examine the company's systems of internal control, to see whether transactions have been **recorded** correctly. They check whether the assets mentioned on the balance sheet actually exist, and whether their valuation is correct. For example, they usually check that some of the debtors recorded on the balance sheet are genuine. They also check the annual **stock take** – the count of all the goods held ready for sale. They always look for any unusual items in the company's **account books** or statements.

Until recently, the big auditing firms also offered **consulting** services to the companies whose accounts they audited, giving them advice about business planning, strategy and restructuring. But after a number of big financial scandals, most accounting firms separated their auditing and consulting divisions, because an auditor who is also getting paid to advise a client is no longer totally independent.

BrE: stock take;
AmE: count of the inventory

C Irregularities



10.1 Match the job titles (1–4) with the descriptions (a–d). Look at A and B opposite to help you.

1 bookkeepers
2 accountants
3 internal auditors
4 external auditors

a company employees who check the financial statements
b expert accountants working for independent firms who review companies' financial statements and accounting records
c people who prepare financial statements
d people who prepare a company's day-to-day accounts

10.2 Match the nouns in the box with the verbs below to make word combinations. Some words can be used twice. Look at A and B opposite to help you.

accounts	procedures	opinions
systems of control	regulations	policies
stock take	advice	laws

check ....
....
....

examine ....
....

comply with ....
....
....
....

give ....
....

10.3 Complete the table with words from A, B and C opposite and related forms. Put a stress mark in front of the stressed syllable in each word. The first one has been done for you. Then complete the sentences below with the correct forms of words from the table.

Verb	Noun	Adjective
–		'accurate
	compliance	–
recommend		
	record	–
	examination	–

1 I'm an internal auditor. I .... the company's accounts, to make sure that they are .... , and that they .... with company policies and general accounting principles.
2 If the control systems aren't adequate, I make .... concerning changes.
3 The external auditors check to see if transactions are being .... correctly.

Over to you

Would you like to work as an external auditor? Do you think they get a very friendly welcome at the companies whose accounts they audit? If not, why not?

11 The balance sheet 1

A Assets, liabilities and capital

Balance Sheet, 31 December 20_ _ ($'000)

Current assets	3,500	Liabilities	6,000
Fixed assets	6,500	Shareholders' equity	4,000
Total assets	10,000	Total liabilities and Shareholders' equity	10,000

Company law in Britain, and the Securities and Exchange Commission in the US, require companies to publish annual **balance sheets:** statements for shareholders and creditors. The balance sheet is a document which has two halves. The totals of both halves are always the same, so they balance. One half shows a business's **assets,** which are things owned by the company, such as factories and machines, that will bring future economic benefits. The other half shows the company's **liabilities,** and its **capital** or **shareholders' equity** (see below). Liabilities are obligations to pay other organizations or people: money that the company **owes,** or will owe at a future date. These often include loans, taxes that will soon have to be paid, future pension payments to employees, and bills from **suppliers:** companies which provide raw materials or parts. If the suppliers have given the buyer a period of time before they have to pay for the goods, this is known as **granting credit.** Since assets are shown as debits (as the cash or capital account was debited to purchase them), and the total must correspond with the total sum of the credits – that is the liabilities and capital – **assets equal liabilities plus capital** (or A = L + C).

American and continental European companies usually put assets on the left and capital and liabilities on the right. In Britain, this was traditionally the other way round, but now most British companies use a vertical format, with assets at the top, and liabilities and capital below.

BrE: balance sheet; AmE: balance sheet or statement of financial position
BrE: shareholders' equity; AmE: stockholders' equity

B Shareholders' equity

Shareholders' equity consists of all the money belonging to shareholders. Part of this is **share capital** – the money the company raised by selling its shares. But shareholders' equity also includes **retained earnings:** profits from previous years that have not been **distributed** – paid out to shareholders – as dividends. Shareholders' equity is the same as the company's net assets, or assets minus liabilities.

A balance sheet does not show how much money a company has spent or received during a year. This information is given in other financial statements: the **profit and loss account** and the **cash flow statement.** (See Unit 14)

11.1 Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 British and American balance sheets show the same information, but arranged differently.
2 The revenue of the company in the past year is shown on the balance sheet.
3 The two sides or halves of a balance sheet always have the same total.
4 The balance sheet gives information on how much money the company has received from sales of shares.
5 The assets total is always the same as the liabilities total.
6 The balance sheet tells you how much money the company owes.

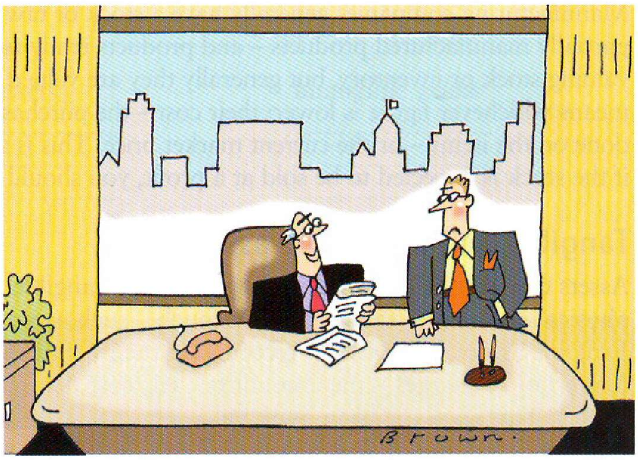
11.2 Complete the sentences. Look at A and B opposite to help you.

1 .... are companies that provide other companies with materials, components, etc.
2 .... are profits that the company has not distributed to shareholders.
3 .... are things a company owns and uses in its business.
4 .... consist of everything a company owes.
5 .... consists of money belonging to a company's owners.

11.3 Make word combinations using a word from each box. Then use the word combinations to complete the sentences below. Look at A and B opposite to help you.

distribute	liabilities
grant	money
owe	profits
pay	earnings
retain	credit

1 We .... a lot of our .... because we don't .... any of our .... to the shareholders.
2 Most businesses have customers who .... , because they .... them 30 or 60 days' ....
3 We have a lot of .... that we'll have to .... later this year.



"I'm afraid our accountants are being investigated for fraud – on the brighter side, our financial statements have made the New York Times best-seller fiction list."

Over to you

Look at the balance sheets of some large companies. What are the most common sub-divisions of these categories: assets, liabilities, and shareholders' equity?

12 The balance sheet 2: assets

A Fixed and current assets

MacKenzie Inc, New York	Balance Sheet 31 December 20__ ($'000)
Current assets	
Cash and equivalents	3,415
Accounts receivable	8,568
Inventory	5,699
Other current assets	5,562
Total current assets	23,244
Non-current assets	
Property, plant and equipment	4,500
Goodwill	950
Long-term investments	6,265
Total non-current assets	11,715
Total assets	**34,959**

In accounting, assets are generally divided into fixed and current assets. **Fixed assets** (or **non-current assets**) and investments, such as buildings and equipment, will continue to be used by the business for a long time. **Current assets** are things that will probably be used by the business in the near future. They include **cash** – money available to spend immediately, **debtors** – companies or people who owe money they will have to pay in the near future, and stock.

If a company thinks a debt will not be paid, it has to **anticipate the loss** – take action in preparation for the loss happening, according to the conservatism principle. (See Unit 7) It will **write off**, or abandon, the sum as a **bad debt**, and **make provisions** by charging a corresponding amount against profits: that is, deducting the amount of the debt from the year's profits.

B Valuation

Manufacturing companies generally have a stock of raw materials, **work-in-progress** – partially manufactured products – and products ready for sale. There are various ways of valuing stock or inventory, but generally they are valued at the **lower of cost or market**, which means whichever figure is lower: their cost – the purchase price plus the value of any work done on the items – or the current market price. This is another example of conservatism: even if the stock is expected to be sold at a profit, you should not anticipate profits.

C Tangible and intangible assets

Assets can also be classified as tangible and intangible. **Tangible assets** are assets with a physical existence – things you can touch – such as property, plant and equipment. Tangible assets are generally recorded at their historical cost (see Unit 7) less **accumulated depreciation charges** – the amount of their cost that has already been deducted from profits. This gives their **net book value.**

Intangible assets include **brand names** – legally protected names for a company's products, **patents** – exclusive rights to produce a particular new product for a fixed period, and **trade marks** – names or symbols that are put on products and cannot be used by other companies. Networks of contacts, loyal customers, reputation, trained staff or 'human capital', and skilled management can also be considered as intangible assets. Because it is difficult to give an accurate value for any of these things, companies normally only record tangible assets. For this reason, a going concern should be worth more on the stock exchange than simply its **net worth** or **net assets:** assets minus liabilities. If a company buys another one at above its net worth – because of its intangible assets – the difference in price is recorded under assets in the balance sheet as **goodwill.**

12.1 Find words and expressions in A, B and C opposite with the following meanings.

1 an amount of money that is owed but probably won't be paid
2 the accounting value of a company (assets minus liabilities)
3 a legal right to produce and sell a newly invented product for a certain period of time
4 the historical cost of an asset minus depreciation charges
5 the amount a company pays for another one, in excess of the net value of its assets
6 a legally protected word, phrase, symbol or design used to identify a product
7 to accept that a debt will not be paid
8 to deduct money from profits because of debts that will not be paid
9 products that are not complete or ready for sale
10 the amount of money owed by customers who have bought goods but not yet paid for them

12.2 Match the two parts of the sentences. Look at A, B and C opposite to help you.

1 A company's value on the stock exchange is nearly always
2 Brand names, trade marks, patents, customers, and qualified staff
3 Cash, money owed by customers, and inventory
4 Companies record inventory at the cost of buying or making the items,
5 Companies write off bad debts, and make provisions
6 Land, buildings, factories and equipment

a are current assets.
b are examples of intangible assets.
c are examples of tangible, fixed assets.
d by deducting the amount from profits.
e higher than the value of its net assets.
f or the current market price, whichever is lower.

12.3 Sort the following into current, fixed and intangible assets. Look at A and C opposite to help you.

buildings	cash in the bank	debtors
goodwill	human capital	investments
stock	land	reputation

Current assets	Fixed assets	Intangible assets
....	....	....
....	....	....
....	....	....

Over to you

Think about the company you work for, or your place of study. What are its most valuable assets? Are they shown on the balance sheet?

13 The balance sheet 3: liabilities

A Liabilities

Liabilities are amounts of money that a company owes, and are generally divided into two types – long-term and current. **Long-term liabilities** or **non-current liabilities** include bonds. (See Unit 33)

Current liabilities are expected to be paid within a year of the date of the balance sheet. They include:

- **creditors** – largely suppliers of goods or services to the business who are not paid at the time of purchase
- planned dividends
- **deferred taxes** – money that will have to be paid as tax in the future, although the payment does not have to be made now.

Current liabilities	
Short-term debt	1,555
Accounts payable	5,049
Accrued expenses	8,593
Total current liabilities	15,197
Non-current liabilities	
Deferred income taxes	950
Long-term debt	3,402
Other non-current liabilities	1,201
Total non-current liabilities	5,553
Total liabilities	**20,750**
Shareholders' equity	
Common stock	10,309
Retained earnings	3,900
Total	14,209
Total liabilities and Shareholders' equity	**34,959**

B Accrued expenses

Because of the matching principle, under which transactions and other events are reported in the periods to which they relate and not when cash is received or paid, balance sheets usually include **accrued expenses**. These are expenses that have accumulated or built up during the accounting year but will not be paid until the following year, after the date of the balance sheet. So accrued expenses are **charged against** income – that is, deducted from profits – even though the bills have not yet been received or the cash paid. Accrued expenses could include taxes and utility bills, for example electricity and water.

C Shareholders' equity on the balance sheet

Shareholders' equity is recorded on the same part of the balance sheet as liabilities, because it is money belonging to the shareholders and not the company.

Shareholders' equity includes:

- the original share capital (money from stocks or shares issued by the company: see Units 29–30)
- **share premium:** money made if the company sells shares at above their **face value** – the value written on them
- retained earnings: profits from previous years that have not been distributed to shareholders
- **reserves:** funds set aside from share capital and earnings, retained for emergencies or other future needs.

BrE: share premium; AmE: paid-in surplus

13.1 Are the following statements true or false? Find reasons for your answers in A, B and C opposite.

1. A current liability will be paid before the date of the balance sheet.
2. A liability that must be paid in 13 months time is classified as long-term.
3. A company's accrued expenses are like money an individual saves to pay bills in the future.
4. Shareholders' equity consists of the money paid for shares, and retained earnings.
5. If companies retain part of their profits, this money no longer belongs to the owners.
6. Companies can sell shares at a higher value than the one stated on them.

13.2 Find words in A, B and C opposite with the following meanings.

1. money that will be paid in less than 12 months from the balance sheet date
2. the money that investors have paid to buy newly issued shares, minus the shares' face value
3. delayed, put off or postponed until a later time
4. built up or increased over a period of time

13.3 Sort the following into assets and liabilities. Look at A and B opposite to help you. You may need to look at Unit 12.

Accounts payable	Land and buildings
Accrued expenses	Investments
Dividends	Cash and equivalents
Inventory	Deferred taxes
Accounts receivable	Long-term debt

Assets	Liabilities
....	....
....	....
....	....
....	....
....	....

"Oh, that three billion dollars."

Over to you

Look at the last two annual reports and balance sheets of your company or one you would like to work for. What differences do you notice in the balance sheets and what reasons can you find for these?

14 The other financial statements

A The profit and loss account

Companies' annual reports contain a **profit and loss account.** This is a financial statement which shows the difference between the revenues and expenses of a period. **Non-profit** (or **not-for-profit**) **organizations** such as charities, public universities and museums generally produce an **income and expenditure account.** If they have more income than expenditure this is called a **surplus** rather than a profit.

Searby PLC

Annual Profit and Loss Account, 1/20_ _

	(£'000)
Sales Revenue	48,782
Cost of Sales	33,496
Gross Profit	15,286
Selling, General and Administrative Expenses	10,029
Earnings before Interest, Tax, Depreciation and Amortization	5,257
Depreciation and Amortization	1,368
Earnings before Interest and Tax	3,889
Interest expenses	257
Income Tax	1,064
Net Profit	2,568

At the top of these statements is total **sales revenue** or **turnover:** the total amount of money received during a specific period. Next is the **cost of sales,** also known as **cost of goods sold** (**COGS**): the costs associated with making the products that have been sold, such as raw materials, labour, and factory expenses. The difference between the sales revenue and the cost of sales is **gross profit.** There are many other costs or expenses that have to be deducted from gross profit, such as rent, electricity and office salaries. These are often grouped together as **selling, general and administrative expenses** (**SG&A**).

The statement also usually shows **EBITDA** (earnings before interest, tax, depreciation and amortization) and **EBIT** (earnings before interest and tax). The first figure is more objective because depreciation and amortization expenses can vary depending on which system a company uses.

After all the expenses and deductions is the **net profit,** often called the **bottom line.** This profit can be distributed as dividends (unless the company has to cover past losses), or transferred to reserves.

BrE: net profit; AmE: net income
BrE: profit and loss account; AmE: income statement

B The cash flow statement

British and American companies also produce a **cash flow statement.** This gives details of cash flows – money coming into and leaving the business, relating to:

- **operations** – day-to-day activities
- **investing** – buying or selling property, plant and equipment
- **financing** – issuing or repaying debt, or issuing shares.

The cash flow statement shows how effectively a company generates and manages cash. Other names are sometimes used for it, including **funds flow statement** and **source and application of funds statement.**

British companies also have to produce a **statement of total recognized gains and losses** (**STRGL**), showing any gains and losses that are not included in the profit and loss account, such as the revaluation of fixed assets.

14.1 Which figure in each of the following pairs is higher for a profitable company? Look at A opposite to help you.

1 cost of sales / sales revenue
2 gross profit / net profit
3 EBIT / EBITDA
4 net profit / pre-tax income
5 income tax / net profit

14.2 Complete the text with words from the box. You will need to use each word more than once. Look at B opposite to help you.

financing	investing	operations

(1) .... means making money by selling goods and services. (2) .... is spending cash, for the business's future growth, including cash acquired by selling assets. (3) .... involves raising money by issuing stocks and bonds (and also paying dividends and interest and repaying bonds). It is better for the company if it can pay for future growth out of money from (4) .... , without having to use (5) .... So a 'healthy' cash flow means that the amount of cash provided by (6) .... is greater than the cash used for (7) ....

14.3 Would the following appear as operating, financing or investing activities on a cash flow statement? Look at the example below to help you.

Changes in operating assets and liabilities	Payments to repurchase stock
Dividends paid	Sale of property
Purchase of plant and equipment	Depreciation and amortization expenses
Net income	Income taxes payable
Issuance of stock	Repayment of debt

Godwin-Malone Inc, New York

Cash flow statement ($'000)	**20_ _**	**20_ _**
Earnings	1,811	1,274
Amortization	924	683
Other adjustments to Earnings	33	–6
Net cash provided from operations	**2,768**	**1,951**
Proceeds from issuing new stock	234	167
Stock dividends paid	–14	
Net cash provided from financing	**220**	**167**
Additions to property, plant and equipment	–2,351	–1,755
Net cash used for investing	**–2,351**	**–1,755**
Change in cash and equivalents during year	**356**	**97**
Cash and equivalents, beginning of year	2,150	2,014
Cash and equivalents, end of year	2,506	2,111

Over to you

Look at cash flow statements in company annual reports, and at the share prices of those companies over the past years. What happened to the share price of companies that generated more cash than they spent, and what happened to those that spent more than they generated?

15 Financial ratios 1

A Types of financial ratio

Financial **ratios** express the relationships between two or more items on financial statements. They allow investors and creditors to compare a company's present situation and performance with its past performance, and with other companies. Ratios measure:

- **liquidity**: how easily a company can turn some of its assets into cash
- **solvency**: whether a company has enough cash to pay short-term debts, or whether it could **go bankrupt** – have its assets sold to repay creditors
- **efficiency**: how well a company uses its resources.

B Liquidity and solvency ratios

$$\frac{\text{current assets}}{\text{current liabilities}}$$

This is the **current ratio**, which is a calculation of current assets divided by current liabilities. It measures liquidity and shows how much of a company's assets will have to be converted into cash in the next year to pay debts. The higher the ratio, the more chance creditors have of being paid. For example, if MacKenzie Inc (see Units 12–13) has current assets of $23,244,000 and current liabilities of $15,197,000, its current ratio is 1.53, which is acceptable. It is often argued that the current ratio of a healthy company should be closer to 2.0 than 1.0, meaning that it has nearly twice as many assets as liabilities.

Suppliers granting short-term credit to a company prefer the current ratio to be high because this reduces their risk. Yet shareholders usually prefer it to be low, because this means that the company has invested its assets for the future.

$$\frac{\text{liquid assets}}{\text{current liabilities}}$$

This is the **quick ratio** or **acid test**, which is a calculation of **liquid assets** divided by current liabilities. It measures short-term solvency. Liquid assets are current assets minus stocks or inventory, as these might be difficult to sell. MacKenzie Inc's quick ratio is 1.15.

C Earnings and dividends

Shareholders are interested in ratios relating to a company's share price, earnings, and dividend payments.

$$\frac{\text{total earnings for the year}}{\text{the number of ordinary shares}}$$

This is **earnings per share** (**EPS**). It tells investors how much of the company's profit belongs to each share. If a company makes a post-tax profit of €1.5 million, and it has issued 2 million shares, EPS = €0.75.

$$\frac{\text{the market price of an ordinary share}}{\text{the past year's EPS}}$$

This is the **price/earnings ratio** or **P/E ratio**. It shows how expensive the share is. If a company has EPS of €0.75 and the share is selling for €9.00, the P/E ratio is 12 (€9 per share divided by €0.75 earnings per share = 12 P/E.) A high P/E ratio shows that investors are prepared to pay a high multiple of the earnings for a share, because they expect it to do well in the future.

$$\frac{\text{ordinary share dividend}}{\text{net profit}}$$

This is **dividend cover** or **times dividend covered**, which shows how many times the company's total annual dividends could have been paid out of its available annual earnings. If a company has EPS of 75 cents and it pays out a dividend of 30 cents, the dividend cover is 75 / 30 = 2.5. A high dividend cover shows that the company has a lot of money, but that it is not being very generous to its shareholders. A ratio of 2.0 or higher is generally considered safe (it means that the company can easily afford the dividend), but anything below 1.5 is risky. A low dividend cover – below 1.0 – means the company is paying out retained surpluses from previous years.

15.1 Find words in A opposite with the following meanings.

1 the ability to sell an asset for cash
2 how well a business uses its assets
3 the relationship between two figures
4 how easily a business can pay bills or debts when they are due

15.2 Make word combinations using a word from each box. One word can be used twice. Then use the word combinations to complete the sentences below. Look at B and C opposite to help you.

acid current dividend liquid quick	assets cover ratio test

1 .... consist of cash and things that can be easily sold and converted to cash.
2 A high .... shows that the company is retaining a lot of money belonging to its shareholders.
3 The .... or .... doesn't count stock or inventory because this might be difficult or impossible to turn into cash.
4 The .... shows a company's ability to pay its short-term debts.

15.3 Match the two parts of the sentences. Look at B and C opposite to help you.

1 If a company pays out retained surpluses from past years
2 Some investors are worried that the new stock issue
3 A high current ratio indicates short-term financial strength but
4 Wall Street is on a historic price-earnings ratio of around 35, which

a it does not measure how efficiently the company is utilizing its resources.
b its dividend cover will fall below 1.0.
c makes the market very expensive, as the long-term average is 14.45.
d will dilute the company's earnings per share.

Over to you

Look at a company's financial statements. Which of the financial ratios mentioned in this unit can be calculated:

- from the balance sheet?
- from the profit and loss account?
- using both these statements?

Which ratios require additional information?

16 Financial ratios 2

A Profitability

There are various **profitability** ratios that allow investors to compare a company's profit with its sales, its assets or its capital. Financial analysts usually include them in their reports on companies.

$$\frac{\text{gross profit (sales – cost of goods sold)}}{\text{sales}}$$

This is the **gross profit margin.** It is the money a company has left after it pays for the cost of the goods or services it has sold. A company with a higher gross profit margin than competitors in its industry is more efficient, and should be able to make a profit in the future.

$$\frac{\text{net profit}}{\text{total assets}}$$

This is **return on assets.** It measures how efficiently the firm's assets are being used to generate profits.

$$\frac{\text{net profit}}{\text{shareholders' equity}}$$

This is **return on equity** (ROE). It shows how big a company's profit is (after interest and tax) compared with the shareholders' equity or funds.

B Leverage

$$\frac{\text{debt}}{\text{shareholders' equity}}$$

This is **gearing** or **leverage**, often expressed as a percentage. It shows how far a company is funded by loans rather than its own capital. A **highly geared** or **highly leveraged** company is one that has a lot of debt compared to equity.

$$\frac{\text{EBIT (see Unit 14)}}{\text{interest charges}}$$

This is **interest cover** or **times interest earned.** It compares a business's annual interest payments with its earnings before interest and tax, and shows how easily the company can pay long-term debt costs. A low interest cover (e.g. below 1.0) shows that a business is having difficulties generating the cash necessary for its interest payments.

BrE: gearing;
AmE: leverage

Citigroup Inc Key Ratios, 2005

	Citigroup	Banking Industry Average	S&P 500 Average
Growth Rates %			
Sales	11.5	29.4	10.7
EPS	3.2	21.2	11.2
Price Ratio			
P/E Ratio	13.9	14.5	20.6
Profit Margins			
Pre-Tax Margin	21.8	23.7	47.3
Net Profit Margin	15.5	16.3	7.6
Financial Condition			
Debt/Equity Ratio	1.9	1.32	1.1
Interest Cover	2.0	2.1	3.4
Investment Returns %			
Return On Equity	15.7	13.2	14.5
Return On Assets	1.2	1.0	2.5

16.1 Match the two parts of the sentences. Look at A and B opposite to help you.

1 After borrowing millions to finance the takeover of a rival firm, the company's
2 Although sales fell 5%, the company's
3 Like profit growth, return on equity is a measure of
4 With just 24% gearing, the company can afford

a gross profit margin rose 9% from a year ago, so senior management isn't worried.
b how good a company is at making money.
c interest cover is the lowest it has ever been.
d to acquire its rival, which would help to increase its steady growth.

16.2 Read the text and answer the questions below. You may need to look at Units 11–14.

Predicting insolvency: the Altman Z-Score

The Z-Score was created by Edward Altman in the 1960s. It combines a set of 5 financial ratios and a weighting system to predict a company's probability of failure using 8 variables from its financial statements.

The ratios are multiplied by their weights, and the results are added together.

The 5 financial ratios and their weight factors are:

A	EBIT / Total Assets	× 3.3
B	Net Sales / Total Assets	× 0.999
C	Market Value of Equity / Total Liabilities	× 0.6
D	Working Capital / Total Assets	× 1.2
E	Retained Earnings / Total Assets	× 1.4

Therefore the Z-Score = A × 3.3 + B × 0.999 + C × 0.6 + D × 1.2 + E × 1.4

Interpreting the Z-Score

> 3.0	– based on these financial figures, the company is safe
2.7–2.99	– insolvency is possible
1.8–2.7	– there is a good chance of the company going bankrupt within 2 years
< 1.80	– there is a very high probability of the company going bankrupt

Which ratio in the Z-Score takes into account:

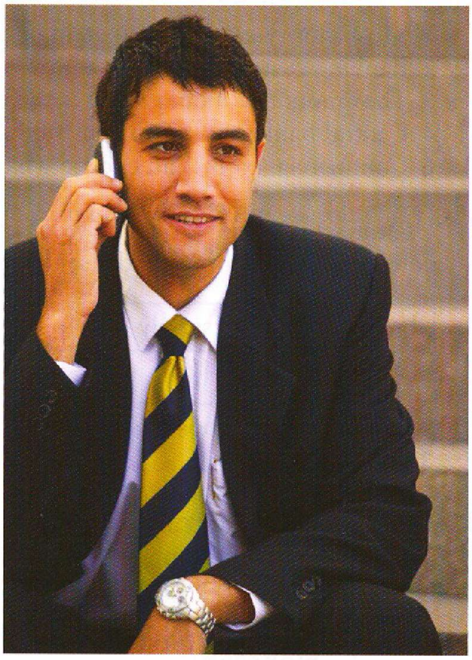
1 money used for everyday expenses?
2 undistributed profits belonging to the shareholders?
3 income or earnings before interest and tax are deducted?
4 the current share price?
5 the amount of money received from selling goods or services?

Over to you

Look at the financial statements of a company you are interested in and calculate the company's Z-Score. Is it in good financial health?

28 Venture capital

A Raising capital



Alex Rodriguez works for a venture capital company:

'As you know, new businesses, called **start-ups**, are all **private companies** that aren't allowed to sell stocks or shares to the general public. They have to find other ways of raising capital. Some very small companies are able to operate on money their **founders** – the people who start the company – have previously saved, but larger companies need to get capital from somewhere else. As everybody knows, banks are usually **risk-averse**. This means they are unwilling to **lend** to new companies where there's a danger that they won't get their money back. But there are firms like ours that specialize in finding **venture capital**: funds for new enterprises.

Some venture capital or risk capital companies use their own funds to lend money to companies, but most of them raise capital from other financial institutions. Some rich people, who banks call **high net worth individuals**, and who we call **angels** or **angel investors**, also invest in start-ups. Although new companies present a high level of risk, they also have the potential for rapid growth – and consequently high profits – if the new business is successful. Because of this profit potential, institutions like pension funds and insurance companies are increasingly investing in new companies, particularly hi-tech ones.'

Note: **Venture capital** is also called **risk capital** or **start-up capital**.

B Return on capital

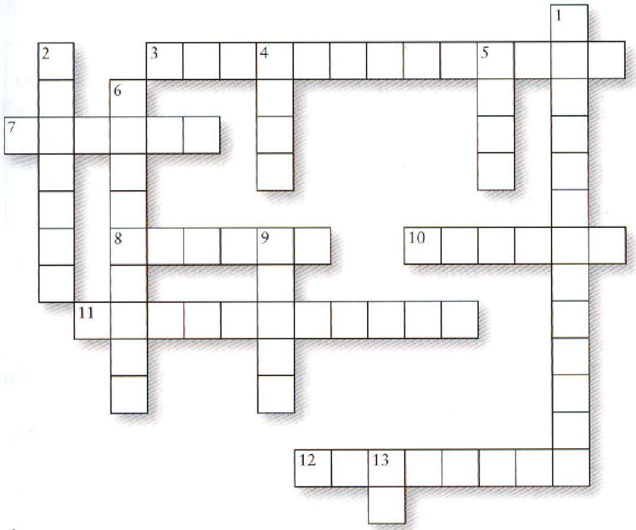
'Venture capitalists like ourselves expect **entrepreneurs** – people with an idea to start a new company – to provide us with a **business plan**. (See Unit 50)

Because of the high level of risk involved, investors in start-ups usually expect a higher than average **rate of return** – the amount of money the investment pays – on their capital. If they can't get a quick return in cash, they can buy the new company's shares. If the company is successful and later becomes a **public company**, which means it is listed on a stock exchange, the venture capitalists will be able to sell their shares then, at a profit. This will be their **exit strategy**.

Venture capitalists generally invest in the early stages of a new company. Some companies need further capital to expand before they join a stock exchange. This is often called **mezzanine financing**, and usually consists of **convertible bonds** – bonds that can later be converted to shares (see Unit 33) – or **preference shares** that receive a fixed dividend. (See Unit 29) Investors providing money at this stage have a lower risk of loss than earlier investors like us, but also less chance of making a big profit.'

BrE: preference shares; AmE: preferred stock

28.1 Complete the crossword. Look at A and B opposite to help you.



Across

3 A firm listed on a stock exchange is a .... (6,7)
7 Individuals who lend money to new companies are sometimes called .... (6)
8 Banks that are risk- .... usually don't want to finance new companies. (6)
10 The amount of money made from an investment is its rate of .... (6)
11 New businesses often have to get finance from .... companies. (4,7)
12 The people who start companies. (8)

Down

1 People who have ideas for setting up new businesses. (13)
2 .... capital firms specialise in financing new companies. (7)
4 Many banks don't want to .... money to new businesses. (4)
5 People who want to borrow money to start a company write a business .... (4)
6 Money invested in a company just before it joins a stock exchange is sometimes called .... financing. (9)
9 and 13 down A new company is often called a .... (5-2)
13 See 9 down.

28.2 Match the two parts of the sentences. Look at A and B opposite to help you.

1 Banks are usually reluctant
2 Start-ups often get money
3 New companies can grow rapidly
4 Risk capitalists usually expect
5 Venture capitalists need an exit strategy – a way
6 Mezzanine financing is a second round of financing

a a higher than average return on their money.
b and so are potentially profitable.
c before a company joins a stock exchange.
d to get their money back after a few years.
e to lend money to new companies.
f from specialized venture capital firms.

Over to you

Would you invest in start-ups? In which fields? If you wanted to start a business, how would you try to raise capital?

29 Stocks and shares 1

A Stocks, shares and equities

Stocks and **shares** are certificates representing part ownership of a company. The people who own them are called **stockholders** and **shareholders**. In Britain, stock is also used to refer to all kinds of securities, including government bonds. (See Unit 33) The word **equity** or **equities** is also used to describe stocks and shares. The places where the stocks and shares of **listed** or **quoted** companies are bought and sold are called **stock markets** or **stock exchanges**.

B Going public

A successful existing company wants to expand, and decides to **go public**.	**go public**: change from a private company to a public limited company (PLC) by selling shares to outside investors for the first time (with a flotation)
↓	
The company gets advice from an investment bank about how many shares to offer and at what price.	
↓	
The company gets independent accountants to produce a **due diligence** report.	**due diligence**: a detailed examination of a company and its financial situation
↓	
The company produces a **prospectus** which explains its financial position, and gives details about the senior managers and the **financial results** from previous years.	**prospectus**: a document inviting the public to buy shares, stating the terms of sale and giving information about the company **financial results**: details about sales, costs, debts, profits, losses, etc. (See Units 11–14)
↓	
The company makes a **flotation** or **IPO** (**initial public offering**).	**flotation**: an offer of a company's shares to investors (financial institutions and the general public)
↓	
An investment bank **underwrites** the stock issue.	**underwrites** a stock issue: guarantees to buy the shares if there are not enough other buyers

Note: **Flotation** can also be spelt **floatation**.

BrE: ordinary shares; AmE: common stock

C Ordinary and preference shares

If a company has only one type of share these are **ordinary shares**. Some companies also have **preference shares** whose holders receive a **fixed dividend** (e.g. 5% of the shares' nominal value) that must be paid before holders of ordinary shares receive a dividend. Holders of preference shares have more chance of getting some of their capital back if a company **goes bankrupt** – stops trading because it is unable to pay its debts. If the company **goes into liquidation** – has to sell all its assets to repay part of its debts – holders of preference shares are repaid before other shareholders, but after owners of bonds and other debts. If shareholders expect a company to grow, however, they generally prefer ordinary shares to preference shares, because the dividend is likely to increase over time.

29.1 Match the words in the box with the definitions below. Look at A, B and C opposite to help you.

bankrupt	prospectus
going public	ordinary shares
flotation	preference shares
investors	stock exchange
liquidation	to underwrite

1 a document describing a company and offering stocks for sale
2 a market on which companies' stocks are traded
3 buyers of stocks
4 changing from a private company to a public one, quoted on a stock exchange
5 the first sale of a company's stocks to the public
6 to guarantee to buy newly issued shares if no one else does
7 shares that pay a guaranteed dividend
8 the most common form of shares
9 insolvent, unable to pay debts
10 the sale of the assets of a failed company

29.2 Are the following statements true or false? Find reasons for your answers in A, B and C opposite.

1 New companies can apply to join a stock exchange.
2 Investment banks sometimes have to buy some of the stocks in an IPO.
3 The due diligence report is produced by the company's own accountants.
4 The dividend paid on preference shares is variable.
5 If a company goes bankrupt, the first investors to get any money back are the holders of preference shares.

29.3 Make word combinations using a word or phrase from each box. Then use the correct forms of the word combinations to complete the sentences below. Look at A, B and C opposite to help you.

offer	an issue
go	a prospectus
produce	shares
underwrite	public

After three very profitable years, the company is planning to (1) .... (2) .... and we're (3) .... 100,000 (4) .... for sale. We've (5) .... a very attractive (6) .... , and although a leading investment bank is (7) .... the (8) .... , we don't think they'll have to buy any of the shares.

Over to you

Have there been any big flotations in the news recently? Are there any private companies whose stocks you would like to buy if they went public?

30 Stocks and shares 2

A Buying and selling shares

After newly issued shares have been sold (usually by investment banks) for the first time – this is called the **primary market** – they can be repeatedly traded at the stock exchange on which the company is listed, on what is called the **secondary market**.

Major stock exchanges, such as New York and London, have a lot of requirements about publishing financial information for shareholders. Most companies use **over-the-counter** (OTC) markets, such as NASDAQ in New York and the Alternative Investment Market (AIM) in London, which have fewer regulations.

The **nominal value** of a share – the price written on it – is rarely the same as its **market price** – the price it is currently being traded at on the stock exchange. This can change every minute during trading hours, because it depends on **supply** and **demand** – how many sellers and buyers there are. Some stock exchanges have computerized **automatic trading systems** that match up buyers and sellers. Other markets have **market makers**: traders in stocks who quote **bid** (buying) and **offer** (selling) prices. The **spread** or difference between these prices is their profit or **mark-up**. Most customers **place** their buying and selling **orders** with a **stockbroker**: someone who trades with the market makers.

B New share issues

Companies that require further capital can issue new shares. If these are offered to existing shareholders first this is known as a **rights issue** – because the current shareholders have the first right to buy them. Companies can also choose to **capitalize** part of their profit or retained earnings. This means turning their profits into capital by issuing new shares to existing shareholders instead of paying them a dividend. There are various names for this process, including **scrip issue**, **capitalization issue** and **bonus issue**. Companies with surplus cash can also choose to buy back some of their shares on the secondary market. These are then called **own shares**.

BrE: own shares;
AmE: treasury stock

C Categories of stocks and shares

Investors tend to classify the stocks and shares available in the **equity markets** in different categories.

- **Blue chips:** Stocks in large companies with a reputation for quality, reliability and profitability. More than two-thirds of all blue chips in industrialized countries are owned by institutional investors such as insurance companies and pension funds.
- **Growth stocks:** Stocks that are expected to regularly rise in value. Most technology companies are growth stocks, and don't pay dividends, so the shareholders' equity or owners' equity increases. This causes the stock price to rise. (See Unit 11)
- **Income stocks:** Stocks that have a history of paying consistently high dividends.
- **Defensive stocks:** Stocks that provide a regular dividend and stable earnings, but whose value is not expected to rise or fall very much.
- **Value stocks:** Stocks that investors believe are currently trading for less than they are worth – when compared with the companies' assets.

30.1 Match the words in the box with the definitions below. Look at A and B opposite to help you.

to capitalize	market price	primary market	own shares
rights issue	secondary market	nominal value	

1 new shares offered to existing shareholders
2 the price written on a share, which never changes
3 to turn profits into stocks or shares
4 the market on which shares can be re-sold
5 the price at which a share is currently being traded
6 shares that companies have bought back from their owners
7 the market on which new shares are sold

30.2 Are the following statements true or false? Find reasons for your answers in A and B opposite.

1 Stocks that have already been bought at least once are traded on the primary market.
2 NASDAQ and the AIM have more regulations than the New York Stock Exchange and the London Stock Exchange.
3 The market price of stocks depends on how many buyers and sellers there are.
4 Automatic trading systems do not require market makers.
5 Market makers make a profit from the difference between their bid and offer prices.

30.3 Complete the sentences. Look at B and C opposite to help you.

1 A stock whose price has suddenly fallen a lot after a company had bad news could be a .... , as it will probably rise again.

2 The stocks of food, tobacco and oil companies are usually .... , as demand doesn't rise or fall very much in periods of economic expansion or contraction.

3 Pension funds and insurance companies, which can't take risks, usually only invest in ....

4 The best way to make a profit in the long term is to invest in ....

5 This stock used to be considered an .... , but two years ago the company started to cut its dividend and reinvest its cash in the business.

6 The financial director announced a forthcoming .... of new shares to existing shareholders.

7 The company is planning a .... of one additional share for every three existing shares.

8 We have bought back 200,000 ordinary shares, which increases the value of our .... to €723,000.

Over to you

If you had a lot of money to invest in stocks, what kind of stocks would you buy, and why?

31 Shareholders

A Investors

Stock markets are measured by **stock indexes** (or indices), such as the Dow Jones Industrial Average (DJIA) in New York, and the FTSE 100 index (often called the Footsie) in London. These indexes show changes in the average prices of a selected group of important stocks. There have been several stock market **crashes** when these indexes have fallen considerably on a single day (e.g. 'Black Monday', 19 October 1987, when the DJIA lost 22.6%).

Financial journalists use some animal names to describe investors:

- **bulls** are investors who expect prices to rise
- **bears** are investors who expect them to fall
- **stags** are investors who buy new share issues hoping that they will be **over-subscribed.** This means they hope there will be more demand than available stocks, so the successful buyers can immediately sell their stocks at a profit.

A period when most of the stocks on a market rise is called a **bull market.** A period when most of them fall in value is a **bear market.**

B Dividends and capital gains

Companies that **make a profit** either **pay a dividend** to their stockholders, or **retain** their **earnings** by keeping the profits in the company, which causes the value of the stocks to rise. Stockholders can then make a **capital gain** – increase the amount of money they have – by selling their stocks at a higher price than they paid for them. Some stockholders prefer not to receive dividends, because the tax they pay on capital gains is lower than the income tax they pay on dividends. When an investor buys shares on the secondary market they are either **cum div**, meaning the investor will receive the next dividend the company pays, or **ex div**, meaning they will not. Cum div share prices are higher, as they include the estimated value of the coming dividend.

C Speculators

Institutional investors generally keep stocks for a long period, but there are also **speculators** – people who buy and sell shares rapidly, hoping to make a profit. These include **day traders** – people who buy stocks and sell them again before the **settlement day.** This is the day on which they have to pay for the stocks they have purchased, usually three business days after the trade was made. If day traders sell at a profit before settlement day, they never have to pay for their shares. Day traders usually work with **online brokers** on the internet, who charge low **commissions** – fees for buying or selling stocks for customers. Speculators who expect a price to fall can **take a short position,** which means agreeing to sell stocks in the future at their current price, before they actually own them. They then wait for the price to fall before buying and selling the stocks. The opposite – a **long position** – means actually **owning a security** or other asset: that is buying it and having it recorded in one's account.

June 1: Sell 1,000 Microsoft stocks, to be delivered June 4, at current market price: $26.20

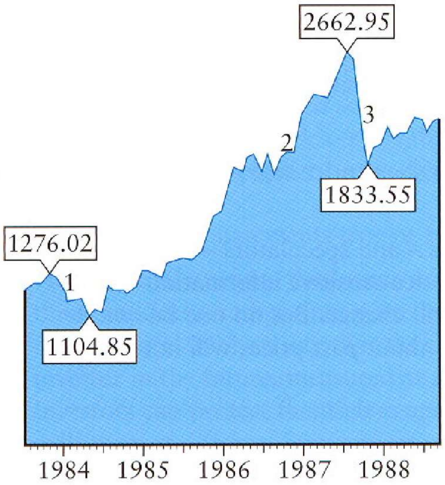
June 3: Stock falls to $25.90. Buy 1,000

June 4: Settlement day. Pay for 1,000 stocks @ $25.90, receive 1,000 x $26.20. Profit $300

A short position

31.1 Label the graph with words from the box. Look at A opposite to help you.

bull market	crash	bear market



1 ....
2 ....
3 ....

31.2 Answer the questions. Look at A, B and C opposite to help you.

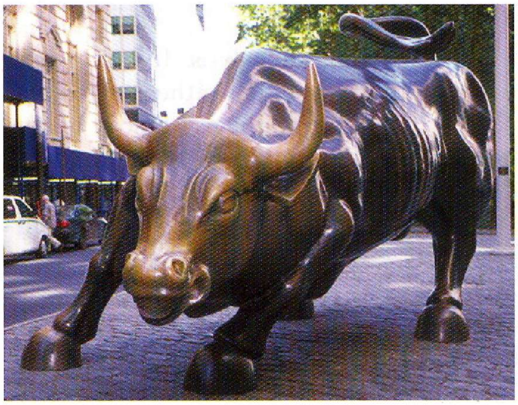
1 How do stags make a profit?
2 Why do some investors prefer not to receive dividends?
3 How do you make a profit from a short position?

31.3 Make word combinations using a word or phrase from each box. Some words can be used twice. Then use the correct forms of the word combinations to complete the sentences below. Look at B and C opposite to help you.

make own pay receive retain take	a capital gain a dividend earnings a position a profit securities tax

1 I .... less .... on capital gains than on income. So as a shareholder, I prefer not to .... a .... If the company .... its .... , I can .... a .... by selling my shares at a profit instead.

2 Day trading is exciting because if a share price falls, you can .... a .... by .... a short .... But it's risky selling .... that you don't even ....



The sculpture of a bull near the New York Stock Exchange

Over to you

Would you like to be a day trader? Or would you be frightened of taking such risks?

32 Share prices

A Influences on share prices

Share prices depend on a number of factors:

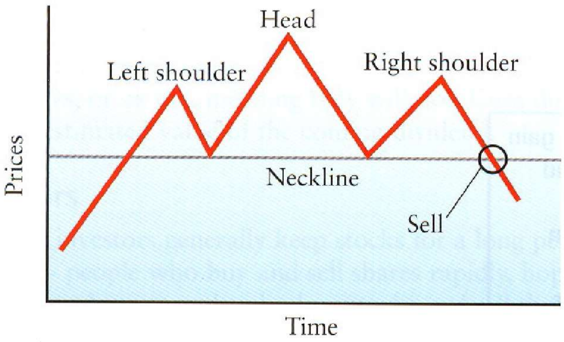
- the financial situation of the company
- the situation of the industry in which the company operates
- the state of the economy in general
- the beliefs of investors – whether they believe the share price will rise or fall, and whether they believe other investors will think this.

Prices can go up or down and the question for investors – and speculators – is: can these price changes be **predicted**, or seen in advance? When **price-sensitive information** – news that affects a company's value – arrives, a share price will change. But no one knows when or what that information will be. So information about past prices will not tell you what tomorrow's price will be.

B Predicting prices

There are different theories about whether share price changes can be predicted.

- The **random walk hypothesis.** Prices move along a 'random walk' – this means day-to-day changes are completely **random** or unpredictable.
- The **efficient market hypothesis.** Share prices always **accurately** or exactly reflect all relevant information. It is therefore a waste of time to attempt to discover **patterns** or **trends** – general changes in behaviour – in price movements.



Head and shoulders pattern

- **Technical analysis.** Technical **analysts** are people who believe that studying past share prices does allow them to forecast future price changes. They believe that market prices result from the psychology of investors rather than from real economic values, so they look for trends in buying and selling behaviour, such as the 'head and shoulders' pattern.
- **Fundamental analysis.** This is the opposite of technical analysis: it ignores the behaviour of investors and assumes that a share has a true or correct value, which might be different from its stock market value. This means that markets are not efficient. The true value reflects the present value of the future income from dividends.

C Types of risk

Analysts distinguish between **systematic risk** and **unsystematic risk.** Unsystematic risks are things that affect individual companies, such as production problems or a sudden fall in sales. Investors can reduce these by having a **diversified portfolio:** buying lots of different types of securities. Systematic risks, however, cannot be eliminated in this way. For example **market risk** cannot be avoided by **diversification:** if a stock market falls, all the shares listed on it will fall to some extent.

32.1 Match the two parts of the sentences. Look at A and B opposite to help you.

1 The random walk theory states that
2 The efficient market hypothesis is that
3 Technical analysts believe that
4 Fundamental analysts believe that

a studying charts of past stock prices allows you to predict future changes.
b stocks are correctly priced so it is impossible to make a profit by finding undervalued ones.
c you can calculate a stock's true value, which might not be the same as its market price.
d it is impossible to predict future changes in stock prices.

32.2 Are the following statements true or false? Find reasons for your answers in B and C opposite.

1 Fundamental analysts think that stock prices depend on psychological factors – what people think and feel – rather than pure economic data.
2 Fundamental analysts say that the true value of a stock is all the income it will bring an investor in the future, measured at today's money values.
3 Investors can protect themselves against unknown, unsystematic risks by having a broad collection of different investments.
4 Unsystematic risks can affect an investor's entire portfolio.

32.3 Match the theories (1–3) to the statements (a–c). Look at B opposite to help you.

1 fundamental analysis
2 technical analysis
3 efficient market hypothesis

a Share prices are correct at any given time. When new information appears, they change to a new correct price.

b By analysing a company, you can determine its real value. This sometimes allows you to make a profit by buying underpriced shares.

c It's not only the facts about a company that matter: the stock price also depends on what investors think or feel about the company's future.

Over to you

Do you believe that it is possible to find undervalued stocks, predict future price changes, and regularly get returns that are higher than the stock market average?

33 Bonds

A Government and corporate bonds

Bonds are loans to local and national governments and to large companies. The holders of bonds generally receive **fixed interest payments**, once or twice a year, and get their money – known as the **principal** – back on a given **maturity date**. This is the date when the loan ends.

Governments issue bonds to raise money and they are considered to be a risk-free investment. In Britain **government bonds** are known as **gilt-edged stock** or just **gilts**. In the US they are called **Treasury notes**, which have a maturity of 2–10 years, and **Treasury bonds**, which have a maturity of 10–30 years. (There are also short-term Treasury bills which have a different function: see Units 25 and 27.)

Companies issue bonds, called **corporate bonds**, because they can usually pay less interest to bondholders than they would have to pay if they raised the same money by a bank loan. These bonds are generally safer than shares, because if a company cannot repay its debts it can be declared bankrupt. If this happens, the creditors can force the company to stop doing business, and sell its assets to repay them. In this way, bondholders will probably get some of their money back.

Borrowers – the companies issuing bonds – are given **credit ratings** by credit agencies such as Standard & Poor's and Moody's. This means that they are graded, or rated, according to their ability to repay the loan to the bondholders. The highest grade (AAA or Aaa) means that there is almost no risk that the borrower will **default** – fail to pay interest or to repay the principal. Lower grades (e.g. Baa, BBB, C, etc.) mean an increasing risk of the borrower becoming **insolvent** – unable to pay interest or repay the capital.

B Prices and yields

Bonds are traded by banks which act as market makers for their customers, quoting bid and offer prices with a very small spread or difference between them. (See Unit 30) The price of bonds varies **inversely** with interest rates. This means that if interest rates rise, so that new borrowers have to pay a higher rate, existing bonds lose value. If interest rates fall, existing bonds paying a higher interest rate than the market rate increase in value. Consequently the **yield** of a bond – how much income it gives – depends on its purchase price as well as its **coupon** or interest rate. There are also **floating-rate notes** – bonds whose interest rate varies with market interest rates.

C Other types of bonds

When interest rates are high, some companies issue **convertible shares** or **convertibles**, which are bonds that the owner can later change into shares. Convertibles pay lower interest rates than ordinary bonds, because the buyer gets the chance of making a profit with the convertible option.

There are also **zero coupon bonds** that pay no interest but are sold at a big discount on their par value, which is 100%, and repaid at 100% at maturity. Because they pay no interest, their owners don't receive money every year (and so don't have to decide how to reinvest it); instead they make a **capital gain** at maturity.

Bonds with a low credit rating (and a high chance of default), but paying a high interest rate, are called **junk bonds**. Some of these are known as **fallen angels** – bonds of companies that were previously in a good financial situation, while others are issued to finance leveraged buyouts. (See Unit 40)

BrE: convertible share; AmE: convertible bond

33.1 Match the words in the box with the definitions below. Look at A and B opposite to help you.

coupon	maturity date
credit rating	principal
gilt-edged stock	Treasury bonds
default	Treasury notes
insolvent	yield

1 the amount of capital making up a loan
2 an estimation of a borrower's solvency or ability to pay debts
3 bonds issued by the British government
4 non-payment of interest or a loan at the scheduled time
5 the day when a bond has to be repaid
6 long-term bonds issued by the American government
7 the amount of interest that a bond pays
8 medium-term (2–10 year) bonds issued by the American government
9 the rate of income an investor receives from a security
10 unable to pay debts

33.2 Are the following statements true or false? Find reasons for your answers in A, B and C opposite.

1 Bonds are repaid at 100% when they mature, unless the borrower is insolvent.
2 Bondholders are guaranteed to get all their money back if a company goes bankrupt.
3 AAA bonds are a very safe investment.
4 A bond paying 5% interest would gain in value if interest rates rose to 6%.
5 The price of floating-rate notes doesn't vary very much, because they always pay market interest rates.
6 The owners of convertibles have to change them into shares.
7 Some bonds do not pay interest, but are repaid at above their selling price.
8 Junk bonds have a high credit rating, and a relatively low chance of default.

33.3 Answer the questions. Look at A, B and C opposite to help you.

1 Which is the safest for an investor?
A a corporate bond B a junk bond C a government bond

2 Which is the cheapest way for a company to raise money?
A a bank loan B an ordinary bond C a convertible

3 Which gives the highest potential return to an investor?
A a corporate bond B a junk bond C a government bond

4 Which is the most profitable for an investor if interest rates rise?
A a Treasury bond B a floating-rate note C a Treasury note

Over to you

Is this a good time to buy bonds? Why/why not?

34 Futures

A Commodity futures

Forward and **futures contracts** are agreements to sell an asset at a fixed price on a fixed date in the future. **Futures** are traded on a wide range of agricultural products (including wheat, maize, soybeans, pork, beef, sugar, tea, coffee, cocoa and orange juice), industrial metals (aluminium, copper, lead, nickel and zinc), precious metals (gold, silver, platinum and palladium) and oil. These products are known as **commodities**. Futures were invented to enable regular buyers and sellers of commodities to protect themselves against losses or to **hedge** against future changes in the price. If they both agree to hedge, the seller (e.g. an orange grower) is protected from a fall in price and the buyer (e.g. an orange juice manufacturer) is protected from a rise in price.

Futures are **standardized** contracts – contracts which are for fixed quantities (such as one ton of copper or 100 ounces of gold) and fixed time periods (normally three, six or nine months) – that are traded on a special exchange. **Forwards** are individual, **non-standardized** contracts between two parties, traded **over-the-counter** – directly, between two companies or financial institutions, rather than through an exchange. The futures price for a commodity is normally higher than its **spot price** – the price that would be paid for immediate delivery. Sometimes, however, short-term demand pushes the spot price above the future price. This is called **backwardation**.

Futures and forwards are also used by speculators – people who hope to profit from price changes.

BrE: aluminium; AmE: aluminum

B Financial futures

More recently, **financial futures** have been developed. These are standardized contracts, traded on exchanges, to buy and sell financial assets. Financial assets such as currencies, interest rates, stocks and stock market indexes **fluctuate** – continuously vary – so financial futures are used to fix a value for a specified future date (e.g. sell euros for dollars at a rate of €1 for $1.20 on June 30).

- **Currency futures** and **forwards** are contracts that specify the price at which a certain currency will be bought or sold on a specified date.
- **Interest rate futures** are agreements between banks and investors and companies to issue fixed income securities (bonds, certificates of deposit, money market deposits, etc.) at a future date.
- **Stock futures** fix a price for a stock and **stock index futures** fix a value for an index (e.g. the Dow Jones or the FTSE) on a certain date. They are alternatives to buying the stocks or shares themselves.

Like futures for physical commodities, financial futures can be used both to hedge and to speculate. Obviously the buyer and seller of a financial future have different opinions about what will happen to exchange rates, interest rates and stock prices. They are both taking an unlimited risk, because there could be huge changes in rates and prices during the period of the contract. Futures trading is a **zero-sum game**, because the amount of money gained by one party will be the same as the sum lost by the other.

34.1 Match the words in the box with the definitions below. Look at A opposite to help you.

backwardation	commodities	forwards	futures
to hedge	over-the-counter	spot price	

1 the price for the immediate purchase and delivery of a commodity
2 the situation when the current price is higher than the future price
3 adjective describing a contract made between two businesses, not using an exchange
4 contracts for non-standardized quantities or time periods
5 physical substances, such as food, fuel and metals, that can be bought or sold with futures contracts
6 to protect yourself against loss
7 contracts to buy or sell standardized quantities

34.2 Complete the sentences using a word or phrase from each box. Look at A and B opposite to help you.

A Commodity futures allow
B Interest rate futures allow
C Currency futures allow

u banks	x food manufacturers
v companies	y importers
w farmers	z investors

1 .... to charge a consistent price for their products.
2 .... to be sure of the rate they will get on bonds which could be issued at a different rate in the future.
3 .... to know at what price they can borrow money to finance new projects.
4 .... to make plans knowing what price they will get for their crops.
5 .... to offer fixed lending rates.
6 .... to remove exchange rate risks from future international purchases.

34.3 Are the following statements true or false? Find reasons for your answers in B opposite.

1 Financial futures were created because exchange rates, interest rates and stock prices all regularly change.
2 Interest rate futures are related to stocks and shares.
3 Financial futures contracts allow companies to protect themselves against short-term changes in exchange rates.
4 You can only hedge if someone who expects a price to move in the opposite direction is willing to buy or sell a contract.
5 Both parties can make money out of the same futures contract.

Over to you

Look at some commodity prices, and decide if you think they will rise or fall over the next three months. Check in three months' time to see if you would have made or lost money by buying or selling futures.

Language reference – British and American vocabulary

British English	American English
aluminium	aluminum
Annual General Meeting (AGM)	Annual Meeting of Stockholders
Articles of Association	Bylaws
balance sheet	balance sheet / statement of financial position
base rate	prime rate
building society	savings and loans association
cash dispenser	ATM (Automated Teller Machine)
chairman	president
cheque	check
convertible share	convertible bond
corporation tax	income tax
cost centre	cost center
creditors	accounts payable
current account	checking account
debtors	accounts receivable
depreciation	depreciation / amortization
Extraordinary General Meeting (EGM)	Special Meeting
financial year	fiscal year
fixed assets	property, plant and equipment
flat	apartment
flotation	initial public offering (IPO)
gearing	leverage
index-linked fund	tracker fund
labour	labor
managing director	chief executive officer (CEO)
Memorandum of Association	Certificate of Incorporation
merchant bank	investment bank
net profit	net income
note or banknote	bill
ordinary shares	common stock
overheads	overhead
own shares	treasury stock
petrol	gasoline
PLC	listed company
preference shares	preferred stock
profit and loss account	income statement
shareholder	stockholder
shareholders' equity	stockholders' equity
shares	stocks
shopping centre	shopping mall
social security	welfare
stock	inventory
stock take	count of the inventory
traveller's cheque	traveler's check
true and fair view	fair presentation
visible trade	merchandise trade

Answer key

1.1
1 social security, salary
2 earn, commission
3 bonus
4 mortgage
5 currency
6 overtime
7 tax
8 rent
9 pension

1.2
1 false – most money … consists of bank deposits
2 true – salaries are usually paid monthly and wages are usually paid weekly
3 false – commission is a percentage of the income they generate, which can change
4 true – money paid by a company or the government to a retired person is a pension
5 false – most people pay one or the other, depending on whether they are buying or renting their home

2.1

				1 L										
		2 I		O				3 B	O	R	R	4 O	W	
5 F	U	N	D	S								W		
		V		S		6 S		7 B	A	L	A	N	C	E
		E				H						E		
		8 S	H	9 A	R	E	H	O	L	10 D	E	R	S	
		T		S		E				I		S		
				S		T				V				
		11 R		E			12 C	A	P	I	T	A	L	
	13 D	E	B	T						D				
		V			14 B	15 O	N	D		E				
		E				W			16 I	N	C	17 O	M	E
	18 I	N	T	E	R	E	S	19 T		D		W		
		U						A				N		
	20 L	E	N	D			21 E	X	P	E	N	S	E	S

3.1
1 bookkeeping, a bookkeeper
2 external auditing, an independent auditor
3 management accounting, a management accountant
4 financial accounting, a financial accountant
5 accounting, an accountant / internal auditing, an internal auditor

3.2 1c, 2e, 3a, 4b, 5d

3.3
carry out an audit
do an audit
establish rules
follow rules
make rules
set rules
apply standards
establish standards
use standards
record transactions
summarize transactions

4.1
1 debit
2 ledger
3 debtors
4 credit
5 stock
6 creditors

4.2 1 Double-entry bookkeeping, account, debit
2 day books, journals
3 nominal ledgers, bought ledger
4 trial balance

4.3 1 debit 3 debit, credit
2 credit 4 credit, debit

5.1 1 false – a company … has a separate legal existence from its owners, the shareholders
2 false – the owners are not fully liable for – or responsible for – the business's debts … Their liability is limited to the value of their share capital
3 true – managers and executive directors run the company for its owners
4 true – Non-executive directors are often more objective
5 false – partners are fully liable or responsible for any debts the business has
6 false – partnerships are not legal entities, so in case of a legal action, it is the individual partners and not the partnership that is taken to court

5.2 corporate governance
audit committee
limited liability
non-executive directors
share capital

1 audit committee 4 limited liability
2 non-executive directors 5 corporate governance
3 share capital

5.3 a Memorandum c purpose
b registered office d authorized share capital

6.1 1 private 4 quoted 7 quarterly
2 stock exchange 5 interim 8 annual report
3 limited 6 listed 9 AGM

6.2 1 misconduct 3 net profit
2 gross profit 4 turnover

6.3 1e, 2a, 3b, 4c, 5f, 6d

7.1 1c, 2e, 3d, 4a, 5b

7.2 1 false – Companies can choose their accounting policies … There are a range of methods of valuation … and measurement
2 false – accounting policies … have to be consistent, which means using the same methods every year, unless there is a good reason to change a policy
3 true – Areas in which the choice of policies can make a big difference include depreciation … [and] the valuation of stock or inventory
4 false – companies have to give a true and fair view of their financial situation – meaning there are various possibilities – rather than the true and fair view – meaning only one is possible
5 true – in many countries accounting follows the historical cost principle: the original purchase price of assets is recorded in accounts, and not their (estimated) current selling price
6 true – some countries with regular high inflation … use inflation accounting systems that take account of changing prices

7.3

Verb	Noun(s)	Adjective
'calculate	calcu'lation	–
–	con'sistency	con'sistent
–	con'vention	con'ventional
'measure	'measurement	–
pre'sent	presen'tation	–
'value	'value, valu'ation	'valuable

8.1 1f, 2d, 3e, 4c, 5b, 6a

8.2
1 financial year / fiscal year
2 subsidiary
3 consolidated financial statements
4 verifiable

8.3

Verb	Noun	Adjective
as'sume	as'sumption	–
dis'close	dis'closure	–
–	objec'tivity	ob'jective
'recognize	recog'nition	–
–	subjec'tivity	sub'jective
'verify	verifi'cation	'verifiable

1 verify
2 disclose
3 objectivity
4 assume

9.1
1 revalue
2 current assets
3 appreciate
4 obsolete
5 fixed assets
6 wear out

9.2
deduct costs
depreciate fixed assets
record market value
record purchase price
reduce profits
reduce value

1 record, purchase price
2 fixed assets, deduct, costs
3 reduce, value

9.3 1e, 2c, 3a, 4b, 5d

10.1 1d, 2c, 3a, 4b

10.2 check accounts
check stock take
check systems of control
comply with laws
comply with policies
comply with procedures
comply with regulations
examine accounts
examine systems of control
give advice
give opinions

10.3

Verb	Noun	Adjective
–	'accuracy	'accurate
com'ply	com'pliance	–
recom'mend	recommen'dation	recom'mended
re'cord	'record	–
ex'amine	exami'nation	–

1 examine, accurate, comply
2 recommendations
3 recorded

11.1

1 true – American and continental European companies usually put assets on the left and capital and liabilities on the right ... most British companies use a vertical format, with assets at the top, and liabilities and capital below
2 false – A balance sheet does not show how much money a company has spent or received during a year
3 true – Since assets are shown as debits ... and the total must correspond with the total sum of the credits ... assets equal liabilities plus capital (or A = L + C)
4 true – shows the company's liabilities, and its capital or shareholders' equity ... Part of this is share capital – the money the company raised by selling its shares
5 false – assets equal liabilities plus capital
6 true – Liabilities are obligations to pay other organizations or people: money that the company owes, or will owe at a future date

11.2

1 Suppliers
2 Retained earnings
3 Assets
4 Liabilities
5 Shareholders' equity

11.3 distribute profits
grant credit
owe money
pay liabilities
retain earnings

1 retain, earnings, distribute, profits
2 owe money, grant, credit
3 liabilities, pay

12.1
1 bad debt
2 net worth / net assets
3 patent
4 net book value
5 goodwill
6 trade mark
7 write off
8 to make provisions
9 work-in-progress
10 debtors / accounts receivable

12.2 1e, 2b, 3a, 4f, 5d, 6c

12.3 Current assets: cash in the bank, debtors, stock
Fixed assets: buildings, land, investments
Intangible assets: goodwill, human capital, reputation

13.1
1 false – Current liabilities are expected to be paid within a year of the date of the balance sheet (if it has been paid, it is no longer a liability and will not appear on the balance sheet)
2 true – current is defined as within a year of the date of the balance sheet
3 true – accrued expenses are charged against income – that is, deducted from profits – even though the bills have not yet been received or the cash paid
4 true – Shareholders' equity includes: the original share capital ... share premium: money made if the company sells shares at above their face value – the value written on them ... retained earnings
5 false – shareholders' equity includes retained earnings – it is money belonging to the shareholders and not the company
6 true – share premium is money made if the company sells shares at above their face value – the value written on them

13.2
1 current liabilities
2 share premium
3 deferred
4 accrued

13.3 Assets: Accounts receivable, Cash and equivalents, Inventory, Investments, Land and buildings
Liabilities: Accounts payable, Accrued expenses, Deferred taxes, Dividends, Long-term debt

14.1
1 sales revenue
2 gross profit
3 EBITDA
4 pre-tax income
5 net profit

14.2
1 Operations
2 Investing
3 Financing
4 operations
5 financing
6 operations
7 investing

14.3 Operating activities: Changes in operating assets and liabilities, Depreciation and amortization expenses, Income taxes payable, Net income
Financing activities: Dividends paid, Issuance of stock, Payments to repurchase stock, Repayment of debt
Investing activities: Purchase of plant and equipment, Sale of property

15.1
1 liquidity
2 efficiency
3 ratio
4 solvency

15.2 acid test
current ratio
dividend cover
liquid assets
quick ratio

1 liquid assets
2 dividend cover
3 acid test, quick ratio
4 current ratio

15.3 1b, 2d, 3a, 4c

16.1 1c, 2a, 3b, 4d

16.2 1 D, 2 E, 3 A, 4 C, 5 B

17.1
1 overheads
2 cost centre
3 variable costs
4 profitable
5 fixed costs
6 breakeven point

17.2

Cost	Direct	Indirect	Fixed	Variable
Advertising expenses		✓		✓
Bad debts		✓		✓
Components	✓			✓
Electricity to run machines	✓			✓
Electricity for heating		✓		✓
Equipment repairs		✓		✓
Factory canteen		✓	✓	
Overtime pay	✓			✓
Raw materials	✓			✓
Property tax		✓	✓	
Rent		✓	✓	

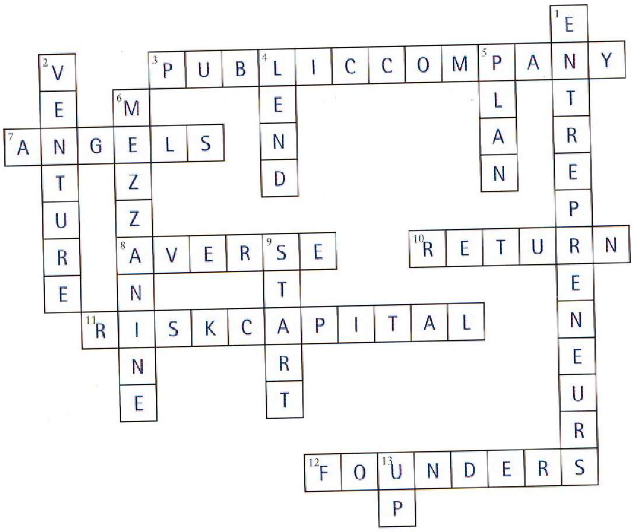
17.3 1a, 2b

18.1 charge prices
cut prices
lower prices
pay prices
raise prices

1 cut/lower
2 raise
3 pay
4 charge
5 cut/lower

18.2
1 prestige pricing
2 odd pricing
3 market skimming
4 mark-up pricing
5 going-rate pricing
6 loss-leader pricing
7 market penetration

28.1



28.2 1e, 2f, 3b, 4a, 5d, 6c

29.1
1 prospectus
2 stock exchange
3 investors
4 going public
5 flotation
6 to underwrite
7 preference shares
8 ordinary shares
9 bankrupt
10 liquidation

29.2
1 false – only successful existing companies can go public
2 true – An investment bank underwrites the stock issue: guarantees to buy the shares if there are not enough other buyers
3 false – The company gets independent accountants to produce a due diligence report
4 false – preference shares … holders receive a fixed dividend
5 false – holders of preference shares are repaid before other shareholders, but after owners of bonds and other debts

29.3
offer shares
go public
produce a prospectus
underwrite an issue

1 go
2 public
3 offering
4 shares
5 produced
6 prospectus
7 underwriting
8 issue

30.1
1 rights issue
2 nominal value
3 to capitalize
4 secondary market
5 market price
6 own shares
7 primary market

30.2
1 false – newly issued shares [are] sold for the first time [on] the primary market
2 false – over-the-counter markets such as NASDAQ … and AIM … have fewer regulations
3 true – market price … depends on supply and demand – how many sellers and buyers there are
4 true – automatic trading systems … match up buyers and sellers
5 true – The spread or difference between these prices is their profit or mark-up

30.3
1 value stock
2 defensive stocks
3 blue chips
4 growth stocks
5 income stock
6 rights issue
7 scrip/capitalization/bonus issue
8 own shares

31.1
1 bear market
2 bull market
3 crash

31.2 Possible answers:
1 They buy stocks in issues that are over-subscribed, so they can immediately re-sell them at a profit.
2 Because if a company makes a profit but does not pay dividends, its stock price will rise, and stockholders can make a capital gain by selling the stocks. Capital gains are taxed at a lower rate than dividends, which are income.
3 By agreeing to sell something at a fixed price, and then buying it at a lower price.

31.3
make a capital gain
make a profit
own securities
pay a dividend
pay tax
receive a dividend
retain earnings
take a position

1 pay, tax, receive, dividend, retains, earnings, make, capital gain
2 make, profit, taking, position, securities, own

32.1 1d, 2b, 3a, 4c

32.2
1 false – Fundamental analysis ... ignores the behaviour of investors and assumes that a share has a true or correct value
2 true – Fundamental analysis ... assumes that a share has a true or correct value, which ... reflects the present value of the future income from dividends
3 true – Investors can reduce these by having a diversified portfolio
4 false – Unsystematic risks are things that affect individual companies (and their shares)

32.3 1b, 2c, 3a

33.1
1 principal
2 credit rating
3 gilt-edged stock
4 default
5 maturity date
6 Treasury bonds
7 coupon
8 Treasury notes
9 yield
10 insolvent

33.2
1 true – The holders of bonds … get their money … back on a given maturity date
2 false – if a company … declared bankrupt … boldholders will probably get some of their money back
3 true – The highest grade (AAA or Aaa) means that there is almost no risk that the borrower will default
4 false – if interest rates rise, so that new borrowers have to pay a higher rate, existing bonds lose value
5 true – floating-rate notes … whose interest rate varies with market interest rates
6 false – convertibles … are bonds that the owner can later change into shares … the buyer gets the chance of making a profit with the convertible option
7 true – zero coupon bonds … pay no interest but are sold at a big discount on their par value
8 false – Bonds with a low credit rating (and a high chance of default) are called junk bonds

33.3 1 C, 2 C, 3 B, 4 B

34.1
1 spot price
2 backwardation
3 over-the-counter
4 forwards
5 commodities
6 to hedge
7 futures

34.2
1 A, x
2 B, z
3 B, v
4 A, w
5 B, u
6 C, y

34.3
1 true – currencies, interest rates, stocks and stock market indexes fluctuate … so financial futures are used to fix a value for a specified future date
2 false – Interest rate futures are agreements to issue … bonds, certificates of deposit, money market deposits, etc.
3 true – Interest rate futures are agreements between banks and investors and companies to issue fixed income securities … at a future date
4 true – the buyer and seller of a financial future have different opinions about what will happen to exchange rates, interest rates and stock prices
5 false – Futures trading is a zero-sum game, because the amount of money gained by one party will be the same as the sum lost by the other

35.1 1c, 2a, 3b, 4d

35.2
1 a, d
2 b, c
3 b
4 a
5 a

35.3
1 Warrants
2 Put options
3 Swaps

35.4
1 premium
2 strike/exercise price
3 call options
4 warrants
5 swap